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PRICES, WAGES AND INFLATION

A SERIES OF ADDRESSES AND PAPERS PRESENTED AT THE SEMI-ANNUAL MEETING OF THE ACADEMY OF POLITICAL SCIENCE
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PREFACE

HAVE the inflationary pressures in the economy of the United States reached the point where public policy needs to be concerned with defenses against an excessively rapid deflation? To what extent have the policies of the Federal Reserve Board and of the Treasury affected the direction and intensity of inflationary pressures during the last decade? Does the federal program in support of agricultural prices interfere with freedom of exchange in the marketplace? Can the American people continue to permit the structure of wages and the movement of prices to be determined by the cumulative influence of thousands of bargains between workers and employers? Does this method of wage-fixing constitute a satisfactory substitute for a national policy concerning wages and prices?

These are a few of the controversial questions considered at the Semi-Annual Meeting (Sixty-eighth Year) of the Academy of Political Science, held in New York City on April 1, 1948. Economists, bankers and government officials presented their variant opinions on the complex problems of prices, wages and credit which still confront the framers of public policy in this tenth year of a major inflation; and their opinions are recorded in this volume of the PROCEEDINGS.

The members of the Committee on Program, who arranged the three provocative conferences, were: George A. Sloan (Chairman), Miss Ethel Warner (Director), B. H. Beckhart, W. Randolph Burgess, Frederic R. Coudert, Lewis W. Douglas, Frank Diehl Fackenthal, Peter Grimm, Alvin Johnson, Nicholas Kelly, Grayson L. Kirk, Sam A. Lewisohn, Henry R. Luce, John J. McCloy, Charles Merz, Frederick C. Mills, Shepard Morgan, Newbold Morris, William L. Ransom, Philip D. Reed, George Roberts, Arthur Hays Sulzberger, Juan T. Trippe, Eliot Wadsworth, Leo Wolman, Philip Young. To them, and to the speakers who helped clarify the issues and suggested possible solutions, the Academy is deeply indebted.

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THE GOVERNMENT AND INFLATION PROBLEMS

INTRODUCTION *

GEORGE A. SLOAN, *Presiding*
Chairman of the Board, Southern Agriculturist
President, The Nutrition Foundation

IN opening this first session of the spring meeting of the Academy of Political Science, I think I am on safe ground in saying that every one of us is painfully aware of high prices and inflation.

While no one in government, industry, labor, or agriculture has thus far been willing to accept even a share of the responsibility, the fact that all four of the culprits are represented at this semi-annual meeting is a most encouraging sign. Perhaps they, too, have had enough! In any event I am sure you share my hope that before the end of the day the speakers at this morning's session, this afternoon's session and this evening will be able to point the way to sanity and perhaps a reversal of a trend that has long since outlived its welcome.

For several years now prices and costs of production have been chasing each other up and up the ascending spiral. Wage increases have led to price increases, and higher prices are cited to support demands for still higher wages. The not so merry merry-go-round goes round and round and up and up.

Some of my economist friends point out that high prices are not a cause, but an incident, of inflation. First among the major

* Opening remarks at the First Session of the Semi-Annual Meeting.

causes, they say, is the terrific increase in the money supply during the past decade. The resultant diluted currency, they say, shrinks in unit value, thereby forcing prices upward with the trend greatly accentuated when the supply of farm products and manufactured goods is less than the demand.

Of course we all realize that our growing foreign commitments and the very real possibilities of increased military expenditures may put an entirely different light on this whole picture.

Before becoming hopelessly involved in an economic treatise, I am going to run to cover and embrace the panel of distinguished economists who have been invited to enlighten us and who, I am sure, are " raring " to go.

Our first speaker, Professor Frederick C. Mills, holds the important chair of Professor of Economics at Columbia University. He is an old friend who is admired by the members of this Academy. He has been studying and teaching economics since he served with distinction as a field artillery " shavetail " in World War I.

Professor Mills wrote *Behavior in Prices* in 1927. In 1936 he wrote, *Prices in Recession and Recovery.* While he did not write the play *Going Up*, he has graciously consented to tell us this morning what has happened to commodity prices since 1939.

COMMODITY PRICES AND THE COMMODITY PRICE STRUCTURE

FREDERICK C. MILLS
Professor of Economics, Columbia University

THE last nine years have witnessed a major inflation in the economy of the United States. Such monetary totals as national income and gross national product, consumers' expenditures, incomes of farmers, the national wage bill, and industrial profits have increased at rates far exceeding those at which the corresponding physical aggregates have been growing—and such a difference is the essence of inflation. It is true that the physical gains have been substantial. This has not been an inflation of the type that impoverishes. Under the froth of rising monetary values a great advance has been scored in the physical basis of national well-being. But the incidence of the physical gains has been uneven, partly because of differences in the degree to which different producing groups have contributed to the real national product, partly because of inequalities among the price advances that these years have brought.

In my discussion of these developments I select for emphasis three aspects of the complex developments of this period.

1. *A characteristic wartime cumulation of price pressures.* In a typical peacetime business expansion the maximum rate of increase in wholesale prices comes in the initial stages of expansion. Thereafter there is deceleration, or constancy of advance at a rate slightly more than half the initial rate. For specific commodities, of course, the maximum pressures and sharpest price increases may come in the terminal stages of expansion, but the average, over-all record, for eighteen peacetime business cycles in the United States, is characterized by pressure on prices that is at its maximum between the turn of the tide and the first third of the period of expansion. The pattern of price change during wartime cycles is sharply and

consistently different. For the periods of the Civil War and World War I the initial rates of price advance were lower than those at any subsequent stage; the terminal rate for the Civil War expansion exceeded 5 per cent a month; for the rise during the First World War it was 2 per cent a month. Wartime price increases, that is, have terminated in explosive advances. If we treat the period from 1939 to 1948 as a phase of cyclical expansion (we may not yet, of course, set a date for the peak) we have a pattern that is close to those of the preceding war periods, in its initial and terminal phases. The initial rate of increase was half of one per cent a month. The price increases in the intermediate stages were at rates only slightly above this. Price controls, taxes and governmental borrowing held inflationary forces effectively in check during the period of fighting. But price movements between June 1946 and January 1948 had that same explosive quality that has characterized past wartime expansions. The rate of advance in wholesale prices in this period exceeded 2 per cent a month. This rapid increase reflected relaxation of constraints after the end of fighting and the influence of depleted supplies and continuing heavy pressures from domestic and foreign demands.

The price recessions that have followed wartime advances, I may note in passing, resemble peacetime movements in that the rate of price decline is a decelerating one, greatest in the early stages of recession. The rate of initial decline after wars, however, has been two to four times as great as in the corresponding stages of recessions following peacetime advances. If we should face a repetition of previous post-war price declines —a prospect to which we do not, I think, have to resign ourselves—we should expect a sharp drop, with possible brief initial acceleration, but with the rate of decline retarded thereafter.

2. *Inversion of the rôles of soft and heavy goods.* The usual pattern of internal shifts during cyclical expansion is marked by the relative elevation of the products of heavy industry. Metals, durables, nonfarm products, nonfoods, materials for use in capital equipment—these are in the van; while soft goods—foods and consumer goods generally, farm products, nondurables—lag in the price advance that marks the usual peacetime expansion. Differences among price movements in

business cycles are not, of course, so pronounced as the differences among physical volume changes, but the price averages for many cycles are marked by stability of foods and other consumer goods, and by wider swings of the materials of heavy industry.

The price advance of 1939-48 has reversed this order. Foods, farm products, nondurables stand at the top of the spectrum. The usually stable consumption sector of the economy has recorded the greatest price increases. (I refer here, of course, to physical goods alone, not to rent and other service items.)

The reasons for this shift are, in the main, familiar. World-wide shortages of foods and other consumer goods for which demands are urgent and inelastic have been a major factor. The high domestic purchasing power of consumers at large, reflecting wartime gains as well as the effects of a slow, secular shift in income distribution that has raised the proportion disbursed to employees, has intensified the pressure on relatively limited supplies. An outstanding feature of the economic movements between 1939 and 1948 was a general lifting of living standards in the United States, a lifting that carried virtually all components of every-day living to levels of consumption exceeding those of the pre-war period.

This up-tilting of the consumer end of the price spectrum means that the price increases of 1939-48 impinge on the pockets and budgets of final consumers more immediately and heavily than in usual cyclical expansions. One result has been that the pressures of rising living costs on wages have been stronger than is usual in peacetime business expansions. The lag formerly characteristic of wages and labor costs has been reduced and indeed eliminated in many industries. Equally important are the enhanced emphasis on consumers' expenditures and the present strategic importance of consumer prices. The willingness and the ability of consumers to continue to absorb goods in high volume are crucial factors in the existing business situation.

Aggregate consumer expenditures in the fourth quarter of 1947 were at an annual rate more than 150 per cent greater than in 1939. The estimated physical volume of goods flowing to consumers was some 40 to 50 per cent greater. For im-

mediate purposes the impressive feature of the record is the sharp divergence between physical volume gains and increases in aggregate consumer outlays in the last 18 to 20 months. Monetary outlays have risen steadily; the stream of physical goods flowing to consumers is but slightly larger than it was in the second quarter of 1946. In large part the increases in dollars spent were offset by rising prices. We have run faster, in the sense that we have spent more dollars, but we have stayed in almost the same place in the matter of real income. In this respect the recent period has a counterpart in the movements between November 1919 and May 1920, when in a splurge of spending consumers scored similar illusory gains.

There is, of course, clear danger in a situation in which price advances do not call out additional supplies of goods. Such price rises in the consumption sector of the economy can cramp consumers, distorting the pattern of their expenditures and reducing their effective buying power. The present existence of an exceptionally high level of prices of consumer goods accentuates threats from this quarter.

3. *The changed cost structure of industry.* An examination of changes in the elements of selling prices of typical manufacturing concerns from 1939 to the end of 1947 reveals a seemingly paradoxical situation. The average advance in the cost of materials entering into a unit of manufactured goods has exceeded the rise in the selling price of that unit; the average advance in labor costs per unit has exceeded the selling-price change; taxes per unit of product at the end of the period were four to five times as great as in 1939. Yet profits, the residual share of enterprise, showed, also, a larger advance per unit of product than did selling prices. Operating profits have, of course, been swelled by rising inventory valuations in 1946 and 1947. But the major explanation of high profits is found in the lagging advance of overhead charges in a period of general price rise, and in the volume factor. Overhead charges are spread today over a volume of output 60 to 70 per cent greater than that of 1939. As of the fourth quarter of 1947 all other major elements of unit selling price were 80 per cent or more above their 1939 levels; overhead costs per unit of manufactured product were at approximately the same level as in 1939.

To a degree perhaps never before approached in our history the present industrial system is geared to high volume. Break-even points are generally well above those of the twenties or the thirties. Labor costs are high, and would be relatively inelastic under downward pressure. Profits are high, but vulnerable. Some of their elements are being removed as inventory valuation gains are cut down. Others will be impaired as depreciation charges, rents and other lagging items are adjusted to the present level of prices. Even modest declines in volume of output would eliminate profit margins for many enterprises and would place strong deflationary pressures upon both labor costs and material prices.

In this brief reference to three distinctive features of the price movements of recent years I have, of course, touched on limited aspects only of the diverse changes of this period. A detailed account of these shifts in terms of exchange and in economic well-being would include the substantial gains that have carried farm prices well above the parity levels of the golden era, 1910-14; the progressive advance in the real worth of an hour of manufacturing labor—an advance that few economic goods have equalled over the last thirty years; the lagging returns of landlords and other creditors (present holders of defense and war bonds bought within the last ten years have suffered a potential loss equal to about one quarter of their investments, a loss that will become real if present price levels hold when the bonds are cashed); the relatively weak position of many salaried and professional groups; the high level of profits relative to pre-war rates; and other familiar characteristics of recent economic changes. The structure of costs and prices thus created reflects, in good part, temporary relations and transitory conditions. The elements of the system—the relations between farm and industrial prices, producer and consumer prices, direct costs and selling prices, and among many other commodity and service groups—are not firmly entrenched. The present price structure is, in important respects, unstable. We must expect fairly extensive internal realignments of its elements, with or without major shifts in the price level.

Since the end of active hostilities American industrialists and responsible administrators at Washington have been in the

curious position of watching for and guarding against both potential inflation and potential deflation. The situation today is no different. Indeed, new elements in the situation accentuate one type of danger, without removing the other. With respect to dangers of a deflationary sort we must note the exposed state of the American economy, its possible brittleness under strain. The prices of farm products are high by all past standards; they are subject to the play of world forces, and to sudden shifts as supply conditions are altered. High prices to consumers are already curtailing demand. A high-cost economy adapted to high volume will encounter serious operating difficulties when output is reduced. To these elements I add certain factors that would retard adaptation to a suddenly lowered price level. Farm price reductions would be fought with economic and political weapons; a labor movement stronger than any that existed after previous wars would resist wage cuts; the traditional lag of administered prices would be experienced. I need cite only these to suggest the obstacles in the way of a general realignment of prices through a sharp recession.

Such a violent realignment, however, is not the only mode of effecting readjustments within the price system as post-war emergencies are met and post-war shortages relieved. Persistent strong demands abroad and the continuing needs of a population enjoying a high living standard at home offer prospects of gradual amelioration of economic stresses. The maintenance of output will make cost reductions possible as productivity gains are realized. Such gains, of considerable magnitude, are potential in the present situation. With high production and advancing productivity, readjustment with modest strains is possible. Correctional movements are necessary in the present price, wage and cost structure; but with sanity and restraint in the areas where conscious actions play leading parts, these movements need not be economically disastrous.

We are not sure today, however, that the stage of deflationary correction has been reached. A new defense program, the dimensions of which we may not yet set, is taking shape. This could be a factor without counterpart in the periods following previous wars. Renewed spending on munitions and equip-

ment, removal of drafted men from the labor market, and other stimulations that go with such a program could renew and intensify pressures toward higher price levels. We should then be concerned not with defenses against deflation but with the renewal of controls to hold expansive forces in check. As Bernard Baruch has already emphasized, such controls would be needed immediately, for the present industrial situation holds no such reservoirs of unused productive power as we were able to tap in the first phase of the preparedness program of 1939-41. Price and wage controls and a system of industrial allocations would be the first order of business in a new defense program.

I do not know which type of pressure we shall be facing six months or a year from now—toward inflationary expansion or toward deflationary contraction. Indeed, the circumstances that will determine these pressures may well be largely non-economic in character. Yet there is one major factor that can play a vital rôle in defenses on both flanks. The maintenance and expansion of production is a direct and obvious defense against inflation. No less essential is the maintenance of volume for the protection of industrial prices, wages and profits. This is perhaps a truism, but it is a truism that has double weight today, given the cost structure and the wage-price-profit relations we have built up over the last nine years. Volume is the key to economic viability under these circumstances. For immediate self-protection an unbroken volume of output is worth almost any price industrial producers and industrial employees might be called to pay—even the price of restraint in exploiting opportunities to advance selling prices and wages. In the present world situation domestic United States production is so essential that its maintenance must be a major objective of public policy and of private endeavor.

Remarks by the Chairman

Chairman Sloan: I am sure that I express the opinion of everyone present in thanking you, Professor Mills, for a most comprehensive, interesting and constructive statement on commodity price trends during the past ten years in general and with particular emphasis on current developments. We were pleased also that you went beyond an analysis of these trends and gave us of your best judgment as to what should be done to correct these trends. I, for one, was very much impressed with what you had to say about the maintenance of production.

It will interest many present who are regular readers of the National City Bank *Monthly Letter* to know that our next speaker, Mr. Norris O. Johnson, Assistant Vice President of the National City Bank of New York, is a valued member of the editorial staff of that unique and distinguished publication. I say this in all sincerity, Mr. Johnson, because I think your bulletin is one of the best in its field.

Mr. Johnson was with the Federal Reserve Bank of New York City for eleven years, during the last three of which he served as manager of its Economic Research Department. In 1945 he served as Treasurer-General of Iran, the third American who has held this post since it was established thirty-five years ago to bring order out of chaos in the finances of that distant country.

It is a very real pleasure at this time to present Mr. Norris O. Johnson, who will discuss "Problems of Checking Overexpansion of Bank Credit". Mr. Johnson!

PROBLEMS OF CHECKING OVEREXPANSION OF BANK CREDIT

NORRIS O. JOHNSON
Assistant Vice President, The National City Bank of New York

THE past five months have provided a rich body of materials for evaluating the problems of checking overexpansion of bank credit in the post-war environment. The environment is peculiar because it has in the background fifteen years of easy-money policies, fifteen years of painful adjustment of financial institutions to unprecedentedly low rates of interest. The purposes sought by the cheap-money policy were to discourage saving and encourage borrowing, and especially to make money cheap for the government. How hard it is to make the switch from easy money to tighter money is evidenced by recent moves in Congress to raise the limits on the amount of mortgages the F. H. A. may guarantee in order to make money cheap and plentiful for the home-builder, especially the veteran. Yet this is the very area of credit which Chairman Eccles of the Board of Governors of the Federal Reserve System, testifying before Congress last November, called " possibly the most inflationary factor in the present situation."

The problems of checking overexpansion of bank credit entered the arena of public discussion toward the end of last year. In his message to Congress November 17 the President opened the debate when he put first on his list of ten proposals for combating inflation, the need for placing some restraint on " inflationary bank credit ". The focal point for concern was the rapid expansion of bank loans in 1947, especially during the fall. Bank loans generally rise during the fall, as the crops are moved, but the expansion last year was abnormally large. For 1947 as a whole, bank loans rose $7 billion. Breaking down the total as best we can from data now available, we get about a $5 billion increase in business loans, a $2 billion increase in real estate loans, a $1 billion increase in consumer credit and miscellaneous other loans. Security loans represented the only major category that declined during 1947. They were down $1 billion.

This $7 billion was of course pretty " small potatoes " compared to the vast inflationary borrowings of the federal government in financing the war. The trouble was that it came on top of the vast wartime inflation of public spending power. In the discussion in and out of Congress, it was quite universally accepted that the root cause of the inflation was wartime finance. Moreover, it was recognized that the expansion of bank loans was as much a result of higher prices as a cause. As Mr. Eccles put it, we were caught up in a wage-price-profit-credit spiral.

Mr. Allan Sproul, President of the Federal Reserve Bank of New York, testifying before the Senate Banking and Currency Committee in early December, elucidated the quantitative aspects of the question. He pointed out that the $7 billion increase in bank loans did not represent a corresponding $7 billion increase in the supply of money—currency and checking account deposits—in the hands of the public. The expansion in bank loans was offset by a decline in bank holdings of government securities made possible by retirement of government debt out of surplus revenues.

Another element that entered into the discussion was the influence of foreign gold sales to the United States Treasury to obtain dollars to cover import requirements. This item, which approached $3 billion in 1947, largely explains the $3.7 billion expansion in money supply experienced during the year.

The upshot of these discussions, which ran through the November-December session of Congress and into the Presidential messages to the new session which opened in January, was that bank lending was essential to the maintenance of high-level production and employment but that banks should exercise extreme caution, confine loans as far as possible to financing that would help production, curtail any loans for speculation in real estate, commodities, or securities and guard against overextension of consumer credit. Two means were adopted, under the traditional heading of " moral suasion ", to interpret these desirable broad national policies into terms of individual bank policies. The national and state bank supervisory authorities issued a joint statement November 24 on bank lending policies and followed it up through their periodic examinations of banks under their jurisdictions. The American Bankers Association launched a voluntary program, endorsed by the President and the Secretary

of the Treasury, to bring to the attention of bankers needs for tightening credit standards and the dangers of lending for unproductive or speculative purposes.

The question naturally came up as to what use was being made of the Federal Reserve's powers of general credit control to restrain bank lending. Here arose the controversy over the adequacy of power. The Federal Reserve Board took the position there was very little that they could do in the existing situation without more powers. On the face of it, this was a rather remarkable position for the Reserve Board to take.

In the 1930's it had been made pretty clear that a central banking system, at least in some circumstances, could not induce an expansion of private credit just by making bank reserves plentiful. As Mr. Eccles put it, very effectively, "You can't push a string." But it is quite obvious that you can *pull* a string. In other words, Federal Reserve policy can be more positively effective in the act of restraint than in the act of encouraging expansion.

In 1935 the Reserve Board sought and obtained, in the Banking Act of 1935, increased powers of restraint to be used when needed; namely, unrestricted authority to increase member bank reserve requirements up to double the statutory percentages. The Federal Reserve Banks had no more than $2.4 billion government securities in their portfolios which could have been sold to take up some of the slack in bank reserves that existed at that time. It was argued, and quite properly, that this was not enough power for restraint. Since the war, however, the Reserve Banks have had upward of $20 billion government securities in their portfolios. Federal Reserve purchases of all these government securities were the mainspring in the vast wartime inflation of the money supply. Why could not some of these securities be sold if the Reserve System wanted to tighten up the supply of credit? The power to do so was enormous and unprecedented.

The obstacle which the Federal Reserve Board saw in using this power was, of course, that it could not put a lot of government securities on the market without driving their prices down, embarrassing banks and other financial institutions generally, and increasing the rates of interest the Treasury would have to pay on current debt refundings. The Reserve Board evidently

felt that very drastic action was called for and that only very drastic action would be effective. It proposed that Congress should authorize a set of "special" reserve requirements running up to 25 per cent on top of the familiar "regular" reserve requirements which currently range, with respect to demand deposits, from 14 per cent for institutions classified as "country" banks up to 22 per cent for "central reserve city" banks of New York and Chicago.

On the other hand, Mr. Sproul felt that an exercise of existing powers on a modest scale might achieve positive results. He felt that with the vast public debt, distributed widely, the credit supply would be sensitive to even small, gradual adjustments in policy. Secretary of the Treasury Snyder shared Mr. Sproul's skepticism that the Reserve Board's proposed new powers would actually accomplish what they were designed to accomplish.

I think there had been efforts, within the Federal Reserve System, to get started with some restraining measures much earlier, and it would have been much better all around if that had happened. As it was, a modest policy of restraint through powers of general credit control was inaugurated in early July with the so-called "defrosting" of the artificial 3/8 per cent rate on 91-day Treasury bills. There was little demand for Treasury bills at this rate and ninety per cent of them were held by the Federal Reserve Banks who bought them, at the 3/8 per cent rate, from anyone who had a better use for his money. The Treasury bill rate was allowed to rise gradually, and later the certificate rate—the rate the Treasury pays for one-year money—was raised first to 1 per cent in October, and to 1 1/8 per cent in January.

The yeast of this modest policy was already working when the problem of restraining bank-credit expansion became front page news in November. At the same time unexpectedly heavy demands for funds were converging upon the credit and capital markets. Utility companies were borrowing to finance new installations, oil companies and many lines of manufacturing were under the same necessity or pressure to expand their facilities and to replace those wearing out or inefficient. In October the federal Treasury borrowed $870 million, obtaining funds to retire the Mellon 4 1/4s and Armed Forces Leave bonds. State and local governments were big borrowers for the first time

since the war, as they raised funds to pay state bonuses to veterans. Expenditures for residential housing rose, almost entirely financed by credit.

At the same time, the wage-price spiral and big high-priced crops put a pressure on all levels of business from primary producer down to the local grocery store for more working capital to finance payrolls and goods in process of manufacture and distribution.

The Treasury-Federal Reserve " modest policy " of restraint, acting upon the supply side of the equation, and the increase in demands developed a powerful reaction in the markets for long-term, fixed-interest securities. The first declines, in preferred stocks, corporate and municipal bonds, got under way in September. In October United States government bonds joined the procession and by the fifth of November the authorities evidently thought the decline had gone far enough and set floors under the prices of long-term government bonds. These floors were reduced, suddenly and without warning, on Christmas Eve after the authorities had purchased $1.8 billion long-term bonds. The markets for corporate and municipal bonds, of course, reacted sympathetically. This gave the market an even greater jolt than the original decline. Bond accounts of many banks and other investment institutions all over the country turned from black figures into red.

Let me recapitulate, now, the measures that were taken, during 1947, to check bank credit expansion:

1. A controlled rise in the Treasury bill rate from 3/8 per cent in early July up to nearly 1 per cent;
2. A rise in the certificate rate from 7/8 per cent in July to 1 1/8 per cent in January;
3. The stabilization of government bond prices November 5 followed by a lowering of support levels December 24;
4. The statement November 24 by bank supervisory authorities urging banks to exercise extreme caution in their lending policies;
5. The launching of the American Bankers Association program to bring the dangers of the situation to the attention of bankers.

The efforts of the bank supervisory authorities and A.B.A., of course, have continued into 1948. The Federal Reserve authorities made two additional moves in January. The Federal Reserve Banks increased their discount rates from 1 to 1¼ per cent and the Federal Reserve Board raised the reserve requirements of the New York and Chicago banks against demand deposits from 20 to 22 per cent. The increases in reserve requirements were made effective February 27.

Meanwhile, the Treasury used a great part of its first-quarter surplus, running to six or seven billion dollars, for directly retiring government securities held by the Reserve Banks. The Reserve Banks, of course, were buying securities in the open market at the time to support their prices, but over all, this operation resulted in a net reduction in Federal Reserve Bank holdings of government securities of nearly two billion dollars between the end of December and the 24th of March.

Now let us take a look at results in terms of the objective—restraining overexpansion of bank credit. We do not yet have data for all banks subsequent to December, but the figures of the weekly reporting member banks in leading cities throughout the country show, practically speaking, no net change in bank loan volumes for the first twelve weeks of 1948:

	Dec. 31, 1947	March 24, 1948	Changes	Changes in corres. period last year
	(In millions of dollars)			
Business loans ...	14,650	14,484	− 166	+ 846
Security loans ...	1,674	1,560	− 114	− 844
Real estate loans	3,459	3,610	+ 151	+ 231
Loans to banks .	106	254	+ 148	+ 108
Other loans	3,439	3,513	+ 74	+ 93
Total loans ...	23,328	23,421	+ 93	+ 434
Government securities	37,227	35,469	−1758	−1573
Other securities .	4,260	4,342	+ 82	+ 146
Total Loans and Securities ...	64,815	63,232	−1583	− 993

The $93 million increase in total loans was entirely accounted for by interbank loans which represent temporary borrowings

of reserves by one bank from another. Other loans items offset each other. Real estate loans were enlarged further—though at a definitely slackened rate—while security loans showed a net decrease. Commercial, industrial and agricultural loans—the broad category of "business loans"—were $166 million smaller on March 24 than they had been in December. In the same twelve weeks of 1947, business loans rose $846 million.

I think it was pretty clear toward the end of last year that banks were going to be a good deal more cautious in putting new loans on their books. But I do not know anyone who predicted that there would be a practical leveling out in bank loans, as actually seems to have happened.

This result is all the more striking in view of the fact that very heavy tax collections by the Treasury were cutting down the money supply and bank holdings of government securities. Increased bank lending has not significantly relieved the deflationary influence of the big cash surplus rolled up by the Treasury since the first of the year.

On the other hand, a new and somewhat unexpected inflationary or reflationary influence has appeared on the stage—namely, lending activities of financial institutions other than banks, financed by sales of government securities to the Federal Reserve Banks. These activities, it is quite evident, have relieved or offset the deflationary effect of the Treasury surplus to a significant extent.

Now let us draw conclusions which this experience suggests:

First, on the question of the need for more powers to curb bank lending, the experience seems to demonstrate pretty clearly that the existing powers, as they have been used, can have very tangible effects even when they are employed on a modest scale.

Second, the emphasis placed on the dangers of overexpansion of bank credit has obscured the fact that nonbank investors have direct access to Federal Reserve credit, under prevailing conditions, and thus an independent capacity to inflate or reflate the money supply.

Third, we need a certain amount of private credit expansion during periods of very heavy Treasury surpluses, such as we have

just come through. If we did not get enough relief in this way we might get more deflation than we bargained for.

The vital point as I see it is to get just the right amount of anti-inflationary pressure through Federal Reserve and Treasury policies. The authorities have large powers, if they are willing to use them, in applying what they conceive to be the right degree of anti-inflationary pressure.

Remarks by the Chairman

Chairman Sloan: Thank you, Mr. Johnson. You have dealt with a most difficult subject, but you have dealt with it with understanding and clarity. Seeing in the audience a good many of your colleagues, who are experienced in monetary and fiscal matters and in this particular problem of bank credit, I think you should be prepared later on for a barrage of questions from the floor.

Professor Friedrich A. Lutz, of the Department of Economics and Social Institutions at Princeton University, has come to us this morning at the request of our Program Committee to discuss "Credit and Finance Policies". Before leaving Germany, Professor Lutz was Lecturer at the University of Freiberg. Shortly after that experience, in 1934 and 1935, he was a Rockefeller Fellow in England and subsequently in the United States in 1937 and 1938. Since that time he has been at Princeton University.

Like Professor Mills of Columbia, Professor Lutz of Princeton is an author of several well-known publications. In 1945, the National Bureau of Economic Research published his *Report on Corporate Cash Balances, 1914-43*. In 1947 the Twentieth Century Fund published the book *Rebuilding the World Economy* written by Professor Lutz together with Professor N. S. Buchanan. Indeed Professor Lutz has written many articles on economic theory and the theory of money and international trade. His latest contribution was a pamphlet this year on the Marshall Plan and the European Economic Policy. It is a pleasure to present to you Professor Lutz.

CREDIT AND FINANCE POLICIES

FRIEDRICH A. LUTZ

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AT the end of December 1947 the volume of money, that is, demand deposits and currency in circulation, amounted to 113 billion dollars. Time deposits, which are a near substitute for money, so near in fact that many economists prefer to include them in money, amounted to 56 billion dollars, and the next near substitute for money, government securities, amounted to 164 billion dollars, counting only those government securities that were held outside the banks. The total amount of money *plus* its near substitutes outside the banks was thus 333 billion, as against a total of 95 billion in June 1940. It is because monetary policy has to be carried out in a milieu which is characterized by such an overabundance of money and its near substitutes that it has become so much more difficult for the monetary authority to control inflationary tendencies than it ever was before.

To illustrate the difficulty which is caused by this overabundance let us look at the events of 1947. Owing to the expansion of business and the rise in prices the demand for investment funds was great. Business firms could satisfy this demand (1) by drawing on their idle cash balances, (2) by selling their holdings of government securities or not replacing them when the securities matured, (3) by borrowing from the banks, (4) by issuing new corporate bonds (or stocks).

The first source is definitely inflationary; it amounts to an increase in the velocity of circulation of money. Indeed the inflation of the last year was to a large extent a " velocity inflation ", resulting not only from the fact that business drew on its idle cash balances, but also from the fact that consumers, once they began to fear further price rises, started to use their cash balances more actively. This inflationary source would not have existed had not inflationary finance during the war increased the volume of money, since 1939, roughly threefold.

The second source, the liquidation of government-bond holdings by business (business holdings declined by 2 billion in 1947) can also be traced to overabundance—overabundance of this near substitute for money. Now, this second source of investment funds is not necessarily inflationary. Sales of government bonds to somewhat reluctant purchasers outside the banking system would simply lead to a drop in bond prices or, what amounts to the same thing, to a rise in the interest rate. But if government bonds are readily bought with idle balances, or if the Federal Reserve Banks buy these bonds in order to keep them at the par level, such sales do increase either the velocity of circulation or the volume of money, and are therefore also inflationary. It is indeed this support policy on the part of the Federal Reserve Banks which makes government bonds held by the public such a perfect substitute for money, and the huge mass of government securities the inflationary danger which it presents today.

The third source of investment funds, bank loans, could, it might seem at first glance, be easily controlled by raising the interest rate on bank loans. But quite apart from the question whether a rise in the interest rate on bank loans is a sufficient check on new borrowing, the banks have no inducement appreciably to raise the rate on bank loans, despite the heavy demand, as long as they themselves have plenty of near substitutes for money in the form of government securities. They can simply sell government securities; as long as the Federal Reserve Banks feel obliged to buy them in order to stabilize the interest rates on government securities, the banks can always by selling governments get additional reserves from the Federal Reserve Banks with which to satisfy the demand for loans on the part of their customers. The elasticity of supply of bank credit is, under these conditions, practically infinite. Again, the inability of the Federal Reserve Banks to control bank-loan expansion can be traced back to the overabundance of near-money, this time in the hands of the banks.

Finally, the fourth source of the demand for funds, the issue of corporate bonds, again need not be inflationary provided the bonds are bought out of current savings. If, however, they are bought out of funds previously held idle, the issue of bonds

leads to an increase in the velocity of circulation of the existing volume of money. Furthermore, corporate bonds are a close substitute for government bonds; and if the purchasers of the new corporate bonds obtain their funds simply by shifting out of government bonds with a lower yield into corporate bonds with a higher yield, the new issues may be inflationary, even though they are not bought with idle balances, provided the government bonds sold by the purchasers of new corporate securities are bought by the Federal Reserve Banks which in exchange create new demand deposits as well as new legal reserves. We are thus back again at the same point: overabundance of money and its near substitutes as the source of the difficulty of controlling credit.

We can express the problem which now confronts the monetary authorities by saying that at present investments are running ahead of savings; that the difference between the two is financed either by hitherto idle cash balances, or by new money created by the sale of government bonds to the Federal Reserve Banks, or by the granting of additional bank loans; and that the monetary authorities pursuing their present policy are apparently unable to close the gap and reduce investments to the volume of current savings or raise current savings to the volume of investments.

Before coming to the main point of my paper, namely, the question of what policies could be pursued by the monetary authorities to check the inflationary tendencies, I would like to point out that there is always a chance that the demand for investment funds may decline of its own accord, while the monetary authorities continue with their present policy which is on the whole passive. (I disregard here such minor anti-inflationary measures as the raising of the rates on short-term securities, and some other steps which the Federal Reserve System has taken.) Such a decline in the demand for investment funds is always a possibility, and if it occurs the inflationary danger will be over at least for the time being; but the problem would only be postponed until the next boom. It is with us as a long-run problem so long as the overabundance of money and its substitutes persists.

What can the monetary authorities do to check the inflation? There are two agencies that can influence the situation, the

Federal Reserve Banks and the Treasury. I take up the Federal Reserve Banks first.

Inasmuch as the inflation is the result of an increase in the velocity of circulation, the Federal Reserve Banks have no direct influence. It is the public alone that decides how fast it wants to turn over its cash balances. If, however, the inflation were only the result of an increase in the velocity, we should not need to be so apprehensive of the future. An increase in the velocity has its limits set by the fact that consumers as well as business firms need to keep cash balances in a relatively stable ratio to their transactions. Only those cash balances that are held in excess of this minimum ratio can be disbursed for expanding investment. As long as such excess cash balances are being dissolved they tend indeed to raise prices; but with the increase in prices the money value of the transactions also increases, so that ultimately the cash balances which were formerly excess balances in the system become part of the necessary minimum of "transactions balances". Once this process has worked itself out, no further inflation need be feared on account of further increases in the velocity of circulation. How far we are at present from this limit I am, however, unable to tell. If the limit is too far off for comfort, then the Federal Reserve Banks would have to check the effects of the increase in the velocity on the price level by contracting the money supply in the economy, and this brings me to the second source of the inflation: the increase in the money supply itself, which can now take place so easily because government bonds can be turned into money either by banks or by individuals. How can such an increase in the money supply be checked or the money supply be contracted if necessary by the Federal Reserve System?

The answer to this question is in a way implied in what I have said so far. Government securities, I said, are near substitutes for money. An individual or a bank can always sell them and obtain money for them. This is, of course, a necessary attribute of a security and cannot be abolished. But we have here sharply to distinguish between an asset which is a substitute for money only for an individual person or institution, and an asset which is a substitute for money even from the point of view of the economic system as a whole. A govern-

ment bond if sold by one individual to another increases the first individual's cash balance but at the same time decreases the other individual's balance. There is no increase in the total volume of money in the system as a whole. But at present, government securities are substitutes for money even from the point of view of the economy as a whole. This is so because whenever sales of government bonds threaten to lower their prices below the par value, the monetary authority which has the power to create money (that is, the Federal Reserve Banks) steps in and buys them in exchange for newly created money. That government securities are substitutes for money even from the point of view of the economic system as a whole is thus the result of a policy decision: the policy of supporting the prices of government securities at their par level. It is clear from this that the necessary condition for an effective check on the expansion of the volume of money is the removal of this support policy which would leave to government securities their character as substitutes for money as regards the individual, but would eliminate it as regards the system as a whole. As far as I can see there is no other method by which the Federal Reserve Banks can check further inflation, if the demand for additional investment funds continues. What would the abandonment of the support policy for government securities imply and what are the objections to it?

Lower government security prices mean higher interest rates. New issues by the government for the purpose of replacing old issues which fall due for repayment would have to be issued at higher interest rates. The rise in the interest rates would not of course be confined to government bonds. The interest rates on all types of securities and even the rates charged to bank customers are all interrelated. If the rates on government securities rise, corporations floating new bond issues will also have to offer higher rates in order to compete with the government bond issues. If bank loans are to remain an attractive investment for the banks, the interest rate charged on them must rise; otherwise the banks will prefer to invest in governments. There is, of course, also a connection between the rates on short-term and long-term securities for fundamentally the same reason. In short, once the support price policy is dropped, the whole level of interest rates in the econ-

omy will rise; and the function of the rise in the level of interest rates would be to check the demand for investment funds so that it is reduced to the level of current savings at the new rates of interest. This would close the gap between investments and savings which was the cause of the inflationary tendency in 1947 and which might continue to cause further inflation.

What are the objections voiced against such a policy? Leaving minor points aside (such as the balance-sheet difficulties facing the banks if they have to write down their bond portfolio) they are, as far as I can see, three in number.

I. It is said that the abandonment of the support policy would flood the market with sales of government securities. These securities are of two types: nonmarketable securities (the so-called savings bonds) and marketable securities. Although the fear has often been expressed that a fall in the prices of marketable bonds would induce the holders of nonmarketable bonds to cash them in, I can see no reason whatever for expecting such a reaction from their present holders. These holders were irrational enough to hold on to them in the face of the continuous decline in their purchasing power caused by the general price rise. They may be expected to hold on to them in the face of a rise in the interest rate on marketable bonds. But *if* the higher interest rate on the marketable bonds induces them to cash their nonmarketable bonds, then their only motive can be the desire to shift into the bonds with the higher yield. Such action on their part does not lead to further inflation; it does not increase the volume of money. Those who are afraid of a selling wave of nonmarketable securities must assume, I think, that the sellers want cash to spend on commodities and that the Treasury which has to provide the cash would have to sell new securities to the banks, a process which increases the volume of money. But I can see no connection between a higher interest rate on marketable government securities and a desire on the part of the holders of nonmarketable securities to spend more money on consumers goods.

So far as marketable securities are concerned, it is reasonable to suppose that banks and other investors would sell if they were afraid of a further decline in prices in the future. A policy which simply lowered the support price level would

probably produce a selling wave because investors might expect a further lowering of the support level in the future. The support would therefore have to be withdrawn entirely. I frankly do not know how investors would then react, and I do not know how far government bond prices would fall. Some bankers have told me that banks would probably sit tight if this policy were followed, and that is quite possible. But I do not feel in a position to make a definite statement on this point.

II. The fear of the authorities of a severe fall in bond prices brings me to the second objection raised against the withdrawal of the support policy. For the Treasury it would mean three things: First a rise, possibly a considerable rise, in the total interest charges on the public debt, charges which now amount to roughly 5 billion dollars a year. This increase in the interest charges would make itself felt as the old issues had to be replaced by new ones; and the Treasury would have a smaller budget surplus, if any, so that it could reduce taxes or the public debt by a smaller amount than would be the case in the absence of such a rise in the interest charges. It is thus simply a question of whether it is worth paying this price for checking inflation. The answer is complicated by the fact that if there is a budget surplus, and it is used to reduce the public debt, this action on the part of the government is also anti-inflationary, or at least can be made so; and then the choice may simply be one between two kinds of anti-inflationary policy. I shall, therefore, reserve my judgment on this point until I speak about this other kind of policy. But if the choice is simply between checking inflation at the price of higher interest charges and a reduction of taxes, I believe that as long as the inflationary tendencies last, it is worth paying the price of renouncing tax reduction in order to stop inflation.

Furthermore the Treasury is afraid that such a fall in government bond prices would damage its credit in the eyes of the public. Here the answer seems to me quite simple: The investor in government bonds has been on the losing side all along because of the inflation; the purchasing power of his bonds has declined to a fraction of the purchasing power which he originally lent. If, at the cost of a fall in the price of long-term government bonds to, say, 80 in the middle of 1946, the

inflation that came after that date had been avoided, the real interests of the investors would have been much better safeguarded than they were by a policy which supported the government bonds at par but let the price level rise by 40 per cent or more; particuarly when we consider that the investor is always reimbursed at par if he holds on to the securities until maturity. I know that the usual answer to this argument is that investors do not " look at it that way." They look at the bond price and are content so long as it does not fall. The inflation they take as an act of God, and not as the result of a policy decision on the part of the monetary authorities. I doubt this very strongly. It may be true for small holders of government bonds, but most small holders have savings bonds which do not fall in price no matter what happens to the interest rate in the market. And the big holders can be expected to have some inkling of what causes the inflation. In any case it seems to me that the authorities should safeguard the *real* interests of the investors in government bonds and not simply what those investors may imagine their interests to be.

Another difficulty facing the Treasury concerns public debt management. This problem is of a very technical nature and I cannot examine it here. The difficulty does not seem to me, however, to be sufficiently great to justify a passive policy on the part of the authorities.

III. There is finally the fear that the rise in the level of interest rates will not merely stop inflation but will cause a recession; a well justified fear. I know of no case in history where the monetary authorities succeeded in stopping an inflation without at the same time causing a recession, for which nobody, naturally, wants to be responsible. But the risk of provoking a recession simply has to be taken, and it may be of some comfort to know that the choice is not simply one between further inflation and recession but one between an early, mild recession and a later, more severe recession. If we have the choice between falling from the second and the fifth floors of a building, the second floor is still to be preferred.

In view of all the difficulties connected with a rise in the level of interest rates, it is understandable that the authorities are reluctant to follow such a policy. Is there any other

method of controlling inflation which will avoid the necessity of a rise in interest rates?

The Federal Reserve Board suggested as such a method the so-called secondary reserve plan which would give the Board additional powers of control. The plan would enable the Board to require of the banks that they should hold additional reserves up to 25 per cent of demand deposits, and 10 per cent of time deposits, in the form of cash, deposits in the Federal Reserve Banks, or short-term government securities. This plan was intended to drive a wedge between the government-security market and the rest of the capital market, so that interest rates on government bonds could be held at their present levels by creating as it were an artificial demand for government securities on the part of the banks, while interest rates on all other securities and on bank loans might rise in response to the increase in the demand for investment funds.

I have not time to discuss this ingenious plan in detail here. Its weakness seems to me to lie in the fact that it underestimates the interconnection between the various parts of the capital market, that is, between the interest rates on different securities. If the rates on corporate bonds were to rise substantially, individual investors, insurance companies, and so on, would have an incentive to shift out of government securities with a low yield into corporate bonds with a high yield. They would sell government bonds which the Federal Reserve Banks would have to buy. This would create new deposits and new reserves for the banks. And although the Federal Reserve System might tie up these reserves for a while by raising the reserve requirements toward the 25 per cent limit, this limit would probably soon be reached. As the plan has, as matters now stand, no chance of being accepted, I need not go further into details. If we disregard the secondary reserve plan as being impracticable, is there perhaps a third method of controlling inflation without at the same time raising the level of interest rates?

It is generally believed that the Treasury by creating a surplus in the budget can stop inflation without affecting interest rates. Now, a budget surplus which is used to reduce the public debt may amount to a sort of " forced " savings on the

part of the community as a whole, provided the public would have spent, and not saved, an amount equivalent to the surplus had it not been forced to turn this amount over to the Treasury. Under these conditions the budget surplus means an increase in savings in relation to investments and the gap between the two diminishes or disappears. If the Treasury chose for instance to redeem, out of its surplus, government bonds held by the banks, the banks could then satisfy a further demand for bank loans simply with the funds received from the Treasury or, ultimately, from the taxpayers. No new creation of demand deposits would be necessary to satisfy the demand for bank loans. The granting of new loans would not be inflationary because, in final analysis, the funds lent come out of additional savings.

This is only true, however, under the conditions I have just stated: namely, that the money which is used to reduce the public debt would otherwise have been used for consumption. If the tax money would have been saved in any case, no net advantage is gained by the budget surplus and the reduction of the public debt, at least not from the point of view of checking the inflation. And the same is true if the taxes are paid out of idle funds or by disinvesting, for example, sales of government securities on the part of the public. We are, therefore, not justified in making a flat statement, as is so often done, that the reduction of the public debt necessarily checks the inflationary tendencies in the economic system. Nor are we justified in asserting flatly that the reduction of the public debt checks inflation without affecting interest rates; and since with the plans for tax reduction and the prospect of increasing expenditures on the part of the government it would be foolish to rely on a budget surplus as a remedy for inflation in any case, I come therefore to the final conclusion that, if the demand for investment funds continues to grow, inflation can be stopped only by letting the interest rates rise.

Remarks by the Chairman

CHAIRMAN SLOAN: Our sincere thanks to you, Professor Lutz. Shortly before the last war, I had the pleasure of visiting the town in Germany where Professor Lutz lectured at his distinguished university. It is sad to realize that this beautiful community was practically obliterated during the war. But it is comforting to know that Professor Lutz is safe and sound in the United States and that he is teaching our youth in one of our great institutions of higher learning.

Our final speaker at this morning's session is Mr. Floyd A. Harper, Chief Economist of the Foundation for Economic Education. He will talk to us on "The Government's Agricultural Policy and Inflation". Mr. Harper, like our other gifted speakers of the morning, is a man of numerous honorary degrees. He not only has had experience as an instructor in agriculture but some twenty years ago he enjoyed and suffered the experience of managing his own farm.

Following a three-year tour of duty in teaching at Cornell from 1928 to 1931, he was field agent of the Federal Farm Board in 1930-31. Later he returned to Cornell as an instructor, still later as an assistant professor of marketing, and for ten years up to 1946 as professor of marketing—all at Cornell.

In Mr. Harper, we have another prominent author in the field of economics. With Mr. F. A. Pearson, he wrote *The World's Hunger.* Some of his other contributions have been *The Crisis of the Free Market, High Prices,* and *Inflation Is on Our Doorstep,* the latter jointly with one of his colleagues. It is a pleasure, Mr. Harper, to present you to the Academy.

THE GOVERNMENT'S AGRICULTURAL POLICY AND INFLATION

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IN this general topic of "The Government and Inflation Problems", my assignment is to test the causal relationship between inflation and the *government's agricultural policy.* During recent months prices have climbed to where butter has sold for a dollar a pound, wheat for more than three dollars a bushel, and cotton for more than 35 cents a pound. In common parlance that is inflation, currently so much disdained. To most persons high prices and inflation are but two names for the same thing.

These high prices have come on the heels of more than two decades during which the belief has been nurtured that an "agricultural program" was necessary to prevent economic destruction of the farming industry. This notion underwent an incubation period of several years after which, in the late twenties, a program was started. Since then it has gone through changes in form and name from time to time. Now and then it became necessary to rechristen this political child, as failure in its avowed purposes made claims of parentage a doubtful honor. As the program now stands, its most vivid part is the "Steagall Amendment" whereby the government establishes price floors for many agricultural products and accepts offerings at that price when the market would otherwise drop below that point in price.

When a person observes the current high prices for food and other agricultural products in the light of this program, the two may seem to be clearly and completely connected as cause and effect. The answer to the question before us seems to be just that simple. But is it? That is the hypothesis to be tested.

Inflation Defined

Before any further discussion, it becomes necessary to define the term *inflation.*

To most persons, as has been said, inflation is a technical term for high prices or for rising prices; but inflation, in this discussion, will be used to describe ***an increase in the means of payment, used in exchange, relative to the volume of exchange being performed.*** " Use in exchange " takes account of changes in the idleness of available money, which is sometimes referred to as " velocity " or " turnover " of money.

Inflation may be defined more simply, but less accurately, as " too much money ".

As inflation progresses under a condition of freedom in exchange, it can be expected to be revealed in the form of higher prices, more or less promptly and proportionately. These higher prices are the *result* of inflation, however, and are not the same thing as inflation. This distinction is important for any correct diagnosis of the inflation disease, if one would hope to treat the disease instead of dabbling with its symptoms.

Under this definition of inflation, then, our question can be reduced to this form: to what extent is the government's agricultural program a cause of increase in the means of payments?

Agricultural Program and Inflation to Date

The inflation that has occurred up to the present time offers an opportunity for post-mortem study of causes. Later we shall speculate on the possible future effects of the program on inflation.

The Test of Relative Sizes

The inflation of which we are speaking, the crime under scrutiny, amounts to a sum of $130 billion to date. That is the amount by which the means of payment [1] has increased from its low point in the early thirties.

As one test of the innocence or guilt of this accused party, the agricultural aid program, we shall first have to arrive at a figure to represent the cost of that program, inflationwise. The resulting figure can then be compared in size with the $130 billion total. There can be no doubt but that the agricultural aid pro-

[1] Total deposits in banks plus currency outside banks. Total deposits are used instead of demand deposits because during the war a large part of the means of payment was stored in this form and is, in the common practice of the banks, convertible into demand deposits at the request of the depositor.

gram has contributed somewhat to the crime of inflation, and is therefore guilty in some degree. But how much?

What should be included in the "agricultural aid program"? It would seem that the subsidy payments of the federal Department of Agriculture should all be included, at a cost of about $10 billion from 1934 to 1947; [2] but that is not all.

A more inclusive figure is the total of "aid to agriculture" appearing in a functional classification of the expenditures of the federal government, with a total of $15 billion for the fourteen-year period. This includes nothing for the loans to agricultural business because they were less at the end of the period than at the beginning, despite a rise over the middle of the period. Nor does it include the costs of several other programs. Is the school lunch program an agricultural program or a school program? Is food for relief an agricultural program or a relief program? Is the T.V.A. an agricultural program or some other program? Not knowing how to settle all these questions with assurance, I shall use the figure of $15 billion for purposes of this analysis.

It might seem, then, that the responsibility of the agricultural program for our inflation to date is 15/130 of the total. In my opinion, however, that would be a mistaken conclusion by overstatement. In explaining the reason for this belief I should like to use the conundrum of the boys on a raft.

It seems that ten boys attempted, simultaneously, to climb aboard a raft that would hold only nine. The raft sank, and the question is: Who sank it? It was the *tenth* boy, but precisely which one was the tenth? Full blame might be placed on each of them, one by one, until in the end it would appear that ten rafts had been sunk, not one. If this dilemma is to be resolved, one must resort to the concept of joint responsibility, and a proportional division of responsibility among the participants.

Similarly it can hardly be said that all of the $15 billion cost of the agricultural program became a part of the $130 billion of

[2] Included in this figure are the payments for conservation and the use of agricultural land resources, parity payments, advances for A.A.A. payments, payments for agricultural adjustment, other A.A.A. payments, Sugar Act payments, exportation and domestic consumption of agricultural commodities. C.C.C. operations in the price support programs and wartime subsidies, etc.

increase in the means of payment. To do so would be to make the same type of error as saying that one particular boy had sunk the raft.

We must, then, adjust the $15 billion downward. The total cost of government, of which this is a part, was financed in part from taxes and in part from funds raised by selling bonds where they did not immediately become a part of the increased means of payment involved in inflation. These non-inflationary forms paid $11 billion of the costs of aid to agriculture. This leaves $4 billion as the corrected figure, or 3 per cent of the $130 billion total.[3]

The importance of the agricultural aid program as thus measured, if we were to express it in terms of the increased cost of a person's food in 1947 as compared with 1933, is $9 per year; the amount due to other causes would be $145, out of the total increase of $154 in food costs.

The Test of Correlation

The correlation method was also used to test the answer to this question. In the interpretation of results by this method, it must always be remembered that a test of relationship is not a definite test of causation. The acid test of causation is to be found in the reliability of the results for purposes of prediction. Does it tell what is going to happen? What degree of confidence does the answer justify in a prediction that a certain result will follow the assumed cause?

By this test of correlation, changes in the agricultural aid program were found to be practically worthless as a basis for predicting the progress of inflation over this period of fourteen years.[4]

[3] If one should prefer to consider demand deposits, instead of time deposits, to be the constituent of means of payment, this figure would become 4 per cent.

[4] The degree of correlation between the two was low and the relationship, however slight, was a negative regression. The fact that the two tended to vary in opposite directions from one another instead of in the same direction as is presumed in our hypothesis, should not lead to the conclusion that inflation should be attacked by increasing the amount of aid to agriculture. Rather, the author prefers to consider this negative regression as one of "chance".

Conflict with Prevailing Opinion

We are forced to conclude, then, that the agricultural aid program to date has been a minor cause of the inflation we have had. Its contribution to inflation has been hardly noticeable in competition with other more important causes, beside which it pales into insignificance in explaining three-dollar wheat and dollar butter.

My topic did not encompass all the causes of inflation. But for the sake of the record, these other more important causes might be noted in passing. The basic cause of the inflation to date has been the newly created money to finance sixteen continuous years of deficits of the federal government, totaling $244 billion. The major contributing cause was the war and its associated costs, but prior to that were ten years of deficit financing. These deficits were financed in part by bonds that did not become new money at that time. But some of the deficits were financed through the banking system in a manner that became the inflation we now bewail.

As people spent this newly created money, the prices of all products, of which food is a significant item, were increased. Food costs were boosted, too, by large shipments of food abroad. And for a few products, like potatoes and eggs, the program of price supports also boosted prices.

Future Effects of Agricultural Program

We have been speaking of the inflation that has already occurred. The agricultural program may, however, become an important contributor to inflation in the future. In judging its threat to inflation in the future, it is helpful to review the past progress of the program.

In the late twenties, when the agricultural aid program was born, the value of production on farms was a little less than $8 billion yearly. Aid to agriculture was then less than $100 million a year.

At the bottom of the depression of the thirties, the value of production on farms fell to about $3 billion yearly and the cost of the aid program for agriculture rose to several hundred million dollars.

Since then *both* farm incomes and aid to agriculture have increased. In 1947 the value of production on farms was $20.7 billion; the " parity income ratio " was 68 per cent higher than in the period before World War I, which is considered to be normal for purposes of most of the " parity price calculations ". Aid to agriculture in 1947 was the highest on record, $2.4 billion! This was several times what it amounted to at the lowest point of the depression of the thirties when corn, unsalable in the western corn belt, was being used for fuel.

Under a new device in the agricultural aid program, the price support scheme, the government now buys any offerings below the support price and then must dump, destroy or dispose of its purchases. You will recall that the government last year bought large quantities of potatoes, then bought kerosene to pour over them, when potatoes were selling for over $2 a bushel in retail stores; these activities were a part of that program.

The price support plan, in effect, means the creation of blank checks for the purchase of products whenever the price falls below the price floor for any reason whatsoever. I would not presume to be able to guess the amount that will be written on these blank checks. It could become tremendous.

Having largely absolved the agricultural program from blame for the inflation that has already occurred, I would not want to absolve it from blame on other counts.

These aid programs should be reviewed from the standpoint of whether or not they are consistent with the outlines of a liberal, voluntary society. To what extent do they interfere with freedom of exchange in the marketplace? To what extent do they abrogate the right of a person to hold property and use it as he sees fit in production? To what extent do they prohibit him from keeping the fruits of his labor, or selling it in the marketplace and keeping the income that he receives therefrom? To what extent do they make farmers the hired men of government, against their will? All such aspects of the program should be reviewed, as well as the question of whether any organization —in this instance the government—is in position to give " aid " to any group when it is $250 billion in debt!

In such a program it is the hope of many to be able to receive subsidies and aid from the government while retaining freedom

to manage their farms as they wish and to sell their products as they wish. They hope to gain the security of a hired man while retaining the freedom of an owner. To all who thus aspire I would quote from the unanimous decision of the United States Supreme Court in a case involving a farmer who contested the government's right to take away his freedom under the program of aid to agriculture: "It is hardly lack of due process for the government to regulate that which it subsidizes." [5]

REMARKS BY THE CHAIRMAN

CHAIRMAN SLOAN: Thank you, Mr. Harper. While I am certain that any audience in any metropolitan city would have listened to Mr. Harper's address with profound interest and approval, I seriously question whether with that address, Mr. Harper, you could be elected to Congress from the state of Iowa! Nevertheless, I am sure that you and your colleagues up at Irvington-on-Hudson are fully conscious of the responsibility that you have assumed in educating the farmer, as well as his city cousin, along sound economic lines.

On behalf of the officers and directors of the Academy, I wish to thank our audience for such a splendid turnout, and, on behalf of the audience, I am sure you would have me thank the speakers of the morning session.

[5] *Wickard* v. *Filburn*, 317 U. S. 111, at p. 131, October term 1942.

PART II

BUSINESS, LABOR AND AGRICULTURE

INTRODUCTION *

SHEPARD MORGAN, *Presiding*
Vice-President, Chase National Bank of the City of New York
Trustee of the Academy of Political Science

THE general topic for this spring meeting of the Academy is " Prices and Credit ". The phase we are going to discuss this afternoon is " Business, Labor and Agriculture ". It is a long time since the Academy has had a purely economic session. I find it singularly refreshing to come to a meeting where we shall deal with such simple and noncontroversial questions as inflation, prices and wages, instead of looking across the water and seeing all of the difficulties that are confronting us as a nation and as individuals. We can rest content with the program as it has been laid down for us this afternoon and be quite sure that there will be no repression of discussion, that there will be no reprisals, no restrictions on speech, no mandates to the press.

The Academy, as you know, has been devoted from the beginning to the rights of the individual, and especially to the instruction of the individual so that he may be better equipped to make up his mind for himself on difficult subjects.

I am glad to introduce as the first speaker, Mr. John C. Virden, a business man from Cleveland, Ohio, who has been induced by Secretary Harriman to be special assistant to the Secretary of Commerce. The subject which Mr. Virden will discuss is this, and I must say it is a long one: " Voluntary Business Agreements and Allocations as a Means of Combating Price Inflation ". Mr. Virden!

*Opening remarks at the Second Session of the Semi-Annual Meeting.

VOLUNTARY BUSINESS AGREEMENTS AND ALLOCATIONS AS A MEANS OF COMBATING INFLATION

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ON December 30 of last year the Congress passed a new anti-inflation bill. In part this bill, known as Public Law 395, contained certain provisions regarding export controls, the use of grain for the production of alcohol and the conservation of food and animal feed. The most prominent feature of the bill, however, was a section providing for the making of voluntary agreements by persons in business, industry and agriculture as a means of combating inflation. In essence the intent of the legislation was to give business the opportunity to help fight inflation by voluntary coöperation rather than by compulsion.

According to the bill, voluntary agreements were to be drawn up providing for priority, allocation and inventory control of scarce commodities which basically affect the cost of living or industrial production.

By executive order the President has delegated to the Department of Agriculture the handling of problems in connection with food under the law. Fuel problems were given to the Department of Interior, and transportation equipment matters to the Office of Defense Transportation. The Department of Commerce was given responsibility for all other commodities and facilities.

In order to protect those who coöperate with voluntary agreements which are drawn up, the law provides that once such an agreement has been approved by the Attorney General persons who comply with it will be protected against proceedings under the anti-trust laws or the Federal Trade Commission Act. Agreements must not last beyond March 1, 1949, and they cannot provide for the fixing of prices.

I have tried to summarize briefly and simply the legal basis for the inflation control program which I intend to discuss. The

aim of the law is to promote the orderly and equitable distribution of goods and facilities in crucial areas of the economy, and thereby stimulate production and help check inflation. The government, in full partnership with industry, develops policy; but it is up to industry itself to carry out any of the programs which are developed.

We have only to recall the activities of O.P.A. and W.P.B. in recent years to recognize that this represents a new departure in dealing with inflation. This action of Congress represents also something of an experiment. During the war, because of the large proportion of our national effort and resources which we were attempting to divert into military lines, it was necessary to establish a very considerable degree of direction by the government over many phases of the nation's life. In World War I there were the first beginnings of extensive economic control by government during a national emergency. In World War II, because of the much greater magnitude of the military effort, these controls were developed and greatly extended.

Since the war there has been a constant tug of war between those who felt that wartime controls should be maintained throughout the period of readjustment and those who felt that controls should be removed as quickly as possible once the actual fighting stopped. Decisions on these difficult questions have been hammered out on the anvil of politics. Public Law 395 is the outcome of this democratic process.

Despite all the differences of opinion which existed and still exist, there has been, nonetheless, general agreement on a few essential points. In the first place it was accepted that controls are at best distasteful, and at worst dangerous to our way of life. It was agreed that controls, because of their character, should be adopted only after other means had failed or in a situation of such character that less stringent devices were patently inadequate. And it was generally accepted, I believe, that, whether or not compulsory measures are adopted in some areas, voluntary measures have a contribution to make to any broad inflation control program. Even during the war, for example, the war bond program and the food conservation programs were both useful and necessary.

I shall not attempt here today to state my views on whether we have too many or too few controls upon our economic life in

terms of the national welfare, or whether we have abandoned too late or too quickly the controls which formerly existed. The President, in November of 1947, recommended to the Congress a 10-point anti-inflation program. The Congress has not given the President the key measures which he felt were essential. On various occasions spokesmen for the Administration have made clear their feelings that the possibilities of voluntary measures should be exhausted before mandatory controls are resorted to. They have also expressed the view that voluntary measures can be most effective when mandatory powers are available to bring into line the few who refuse to coöperate. It has been the President's view that the hour is too late in the fight against inflation to place our main reliance upon voluntary action.

Personally, I am optimistic about the potentialities of voluntary methods in helping to deal with inflation. I believe they have a vital part to play in our present situation.

First, if they can be operated successfully, voluntary restraints will be an important example of democracy in action. I believe, as I suspect most of you do, that we in our lifetimes are due to face a succession of difficult situations. In all of these which are of a major character for the nation a recurrent issue will be presented: whether we are going to be able to meet the needs by voluntary coöperation and participation in a national effort, or whether we are going to resort to some means of compulsion.

The healthier our democracy is, the more of these situations we can handle by coöperative rather than mandatory devices. And, conversely, the more we handle by coöperative means—the more that our people participate in the responsibilities of coöperative effort—the stronger our democracy will be.

In the second place, great as our problems are today they are nevertheless smaller than those we successfully overcame during the war. I believe I am correct in saying that we turned something like 40 or 50 per cent of our national effort into the war. Now we are planning to divert only a fraction of that amount in fulfilling our world responsibilities. The extraordinary requirements of war called for extraordinary methods of directing our energies into essential lines and insuring that our most important needs were met first. The character of our peacetime program, as well as its smaller magnitude, offers opportunity for voluntary measures to be highly useful.

It is a truism, but one that is sometimes forgotten, that controls do not directly increase the supply of goods. They may be necessary at times to achieve more equitable distribution of supplies, and in this sense they can be a means to the end of increased output. If improperly administered, however, they may retard production and thereby aggravate the very situation they are intended to remedy. The program we are now carrying out is aimed directly at increasing production by breaking bottlenecks and by making more effective use of supplies which are essential to increase production. We are trying by our actions to be a positive influence to help, not hamper, industry in doing its job.

I am confident that if American industry is given the help it needs it will do its full share in overcoming the discrepancy that now exists between needs and supplies. Since the war American industry has established new records of ingenuity and productivity. During the war I had a favored position to watch and admire the genius of American production. I was Regional Director for the War Production Board in the area which included such manufacturing cities as Cleveland, Pittsburgh, Dayton and Louisville. That experience made me an unrepentant champion of the American system of individual enterprise. In the postwar period I have been no less impressed with what our industry and agriculture have been able to do.

Now, I have talked at considerable length about the background, the purposes and the possible effects of the voluntary inflation control program. What has been done to put that program into effect? Since I am a member of the Department of Commerce I can speak only of the things which we have done under this program.

To carry out his responsibilities under Public Law 395, Secretary of Commerce Harriman set up an Office of Industry Cooperation to serve as his principal agent in the preparation of proposed voluntary agreements with business and industry.

In general, the Office of Industry Cooperation does the following things: It recommends to the Secretary the organization and composition of industry advisory committees; it arranges for convening these committees and keeping records of their activities; it arranges for the preparation of necessary materials and information in order to carry on negotiations leading to

voluntary agreements. It consults with labor groups in conjunction with the program, and carries on public hearings in order to give all groups an opportunity to present their views on proposed agreements. It prepares and submits to the Attorney General, for his approval, voluntary agreements which are arrived at. It reviews voluntary agreements which are in operation and proposes and negotiates modification as necessary.

As you can see our work revolves around these industry advisory committees and the preparation of voluntary agreements. We have tried, in setting up these committees, to make them as representative as possible of the industry affected. We have made sure that small as well as large concerns in each industry are represented, and we have taken into account such other factors as geographical distribution, trade association membership, degree of integration, and the like.

We feel this is of the highest importance in order to get the best possible advice on proposed agreements.

These committees have the function of furnishing information and giving advice and recommendations to the Department of Commerce on problems affecting an industry either in connection with making a voluntary agreement or in connection with an existing agreement. These committees are not authorized to determine policies of the industry, nor are they authorized to compel or coerce anyone to enter into agreements or to comply with requests made under the program.

I should like to describe to you chronologically some of the main problems we have faced and the decisions we have arrived at in our work. Needless to say, we had to start practically from scratch. You all have heard about the difficulty which faces the government these days in recruiting experienced and capable men. The problem of putting a staff together is one that we are still working on, but I am happy to say that owing to the coöperativeness of a number of industries, and perhaps to a measure of good luck, we have had considerable success.

A second problem was to decide upon a general approach in getting the work under way. We could have spread the O.I.C. all over the papers by inviting a great number of industries to Washington for consultation. It was our feeling that this would merely have been window dressing and would not have been a practical or realistic approach. In working with industry to

allocate materials to certain concerns and not to others, you must proceed with care and give full consideration to the consequences. You must sight down the gun barrel and see where you are shooting. Otherwise, you will only bring about confusion, resentment and hardship.

We initially selected four areas in which we felt there were critical shortages basically affecting the cost of living and industrial production. These were railroad equipment, petroleum equipment, agricultural equipment, and low-cost housing. As time goes on, it may be necessary to add other industries to this list.

Inasmuch as steel was a factor basic to each of the industries designated as critical we set about the task of gaining the coöperation of the steel industry. Here also we decided to proceed with caution. We did not contemplate allocations of steel to end-use generally. The Department of Commerce did not contemplate its being an expediter for the steel requirements of individual firms throughout the country.

Instead, we decided to direct our efforts toward three goals: increasing output; encouraging conservation in unessential lines; and helping industries designated as critical to secure adequate supplies of steel.

We are now working with the steel industry in getting raw materials that are necessary to keep production as close to capacity as is humanly possible. Scrap is the basic shortage. We have requested the principal scrap-producing industries and also government agencies to review their programs and to bring as much scrap as possible into the market at this time. We are also giving consideration to questions of increasing the supplies of high-grade coking coal.

With respect to conservation of steel in the less essential uses we have consulted with various industrial users and have encouraged them to develop programs for making full use of substitute materials and steel-saving methods. Industries are being approached to see if they can defer maintenance and construction programs that do not affect their ability to take care of immediate needs.

The principal problem is, of course, in drawing up a system of priorities and allocations in order to insure that the most critical needs for steel at the present time are filled. We have

appointed a strong steel advisory committee which is thoroughly representative of the industry, and we have obtained the services of three widely known advisers who work intimately with us.

Other committees have been set up to make recommendations on the steel requirements of essential industries with critical supply problems; to advise the Department of Commerce on available supplies of various steel products needed; and to recommend allocations of tonnage, by products, among steel producers.

When an individual concern has been assigned a certain amount of steel or pig iron under the program, that concern makes its own arrangements with its suppliers for obtaining the material. When steel or pig iron is made available to a specified consumer, it is agreed that he shall not use such material for any purpose other than that for which it was assigned.

One kind of voluntary agreement which has already produced substantial results has been sponsored by the Office of Defense Transportation for the purpose of increasing production of freight cars. Under this voluntary program a number of steel companies have been supplying steel to freight car builders. It is our hope that similar programs can be developed for other scarce products. Because the anti-inflation bill encompassed this problem and because steel was one of the responsibilities delegated to the Department of Commerce under the Act, the freight car program—formerly under the Office of Defense Transportation—has become part of the responsibilities of the Office of Industry Cooperation. We have finally formalized the freight car agreement, and have already held a public hearing at which all interested parties were heard. That agreement has now been approved by the Secretary of Commerce and the Attorney General. That agreement and the public hearing which followed it have set a pattern for other agreements which will come along later.

I wish I could report that a number of agreements had already been worked out in the other three fields on which we are concentrating, but this is not the case. If you could see the complex nature of the problems in the fields of petroleum equipment, agricultural equipment and low-cost housing, I feel sure you would understand why slow progress was to be expected.

In regard to petroleum equipment, the Department of Interior has been working for a number of weeks with the petroleum industry to determine how much steel will be needed to increase production and put production and transportation facilities into better balance with available refining capacity. The Department of Commerce and O.I.C. are now at work to see how practical it may be to meet these urgent requirements without dislocating the economy too much.

In the field of low-cost housing, we have scheduled a number of meetings with the industries involved. We are now in the process of finding out what is needed to increase the number of houses being built and learning ways and means of doing it.

In connection with agricultural equipment, we have met with representatives of that industry, and an advisory committee has been set up. It is the feeling of the industry representatives with whom we consulted that they will be able to meet their requirements for supplies without taking part in the coöperative procedures under the program. I regret they have taken the stand they have, and I feel sure that if they had joined with us on the same basis as other industries have we could do a better job of working out our problems together. Their action, however, is consistent with the terms of the program—which is purely voluntary. No representative of industry, business or agriculture is compelled to consult with the President or his representatives, nor are they compelled, after consultation, to enter into any agreement.

In addition to our meetings with the steel industry and the four essential steel-using industries, we have met with a number of other groups from the following industries: namely, textiles, soda ash, nitrogen and others. The main objective in all these discussions is to have the industry itself tell the Department of Commerce what seems to be missing, and then have government and business sit down and work out jointly ways and means of overcoming the obstacles.

We would be foolish to claim that we have accomplished any great amount of good in so short a time. We are certainly not rash enough to make predictions as to the effectiveness of voluntary measures in the future. I am, however, definitely encouraged over the coöperation shown by a number of industries to date, and I am optimistic about further progress that can be made.

In conclusion I want to make just two points. First, since this program is purely voluntary, it is up to business to take the lead and to do whatever must be done. This program will be a test case of the potentialities of voluntary methods, and its significance will extend far beyond the immediate situation. Success we achieve now will go a long way toward encouraging the use of voluntary methods to a maximum degree whenever future emergencies arise.

Secondly, we are of course in a situation of considerable uncertainty. We cannot at this moment predict what new obligations the events of the next few months and even the next few weeks may impose upon us. It may be that vast new requirements will overtax the potentialities of any voluntary system and require stronger methods. Or, it may happen that continued progress in raising our production, combined with favorable developments on the international scene, will make it possible for us to ride through the storm safely and without resort to further measures of control. We are at the present time confidently and diligently working to get the maximum benefit possible from voluntary measures. Whatever develops in the future, any progress we can make along the lines that we are now following will be that much of a contribution to our security against the dangers of inflation at home and aggression abroad.

Remarks by the Chairman

Chairman Morgan: It is a great thing here in New York to have someone come from Washington with a speech in his pocket and not read it. I must say that there is a ring of authenticity in what Mr. Virden has said that one never gets in a speech that is prepared by someone else.

Our next speaker this afternoon is Sumner H. Slichter, Professor in Harvard University. Doubtless you are familiar with the very illuminating pieces that he writes, almost in every edition of *The New York Times Magazine*, on matters of economic importance. Will Mr. Slichter come to the platform?

WAGES AND PRICES

SUMNER H. SLICHTER
Harvard University

I

THE great spread of collective bargaining is daily making the relationships between wages and prices of more and more importance. No longer are wage movements explained in the main by the demand for labor. More and more, wages are the result of the wage policies of trade unions and more and more they are a determinant of prices rather than being determined by them. My remarks on wages and prices will be divided into three main parts. First, I wish to look briefly at what has been going on during the two and a half years since V-J Day; second, to look at the immediate future of wages and prices; and third, to examine the long-run outlook for wages and prices and some of the problems suggested by it. It is desirable, however, to preface these discussions with a few theoretical observations.

II

Wages and salaries in 1947 constituted 55.5 per cent of all costs of producing the private net national product. They also constituted 52.4 per cent of all personal incomes. Since wages are a large part of the cost of production and also a large part of personal incomes, the relationship between wages and prices is bound to be close. It is obviously a twofold relationship—a cost-price and a demand-price relationship. Under some conditions, changes in wages may affect prices more as a cost than as a source of demand; under other conditions, changes in wages may affect prices more as a source of demand than as a cost. Sometimes the cost effect of wages on prices may be in the same direction as their demand effect. At other times the two effects may be in opposite directions—as when a rise in wages diminishes the size of payrolls.

Despite the closeness of the relationship between wages and prices, there are many years in which the two move in opposite directions. During the 107 years between 1840 and 1947, there were 57 years when the annual average of wholesale prices was

above the preceding year, 48 when it was below, and 2 in which it was the same. There were 72 out of the last 107 years, however, when the annual average of hourly earnings of nonagricultural workers was above the preceding year, 17 when it was below, and 18 when it was the same. There were 28 times during the last 107 years when the year-to-year movements of wholesale prices and the hourly earnings of nonagricultural workers were in opposite directions—in 24 years wages were rising when prices were dropping, and in 4 years wages were dropping when prices were advancing. There were 7 years when the annual average of wages did not change but when prices were going up, and 11 years when wages did not change but the annual average of prices dropped. The times when wages were rising and prices were falling were, as a rule, early in recessions, and the times when wages were declining and prices were advancing were in the early phases of revival.

Generalizations about wage-price relationships, which hold for periods of expanding demand, will not necessarily hold for periods of contracting demand. As the above figures indicate, the middle and later phases of expansion are times when wages adjust themselves to prices; periods of contraction are times when wages and prices are more or less independent of each other; and early phases of expansion are periods when prices are adjusting themselves to wages. Particularly striking is the fact that in *half* of the years when the annual average of prices dropped (namely, 24 out of 48) the annual average of wages rose.

Of crucial importance are shifts or expected shifts in the labor supply curve in response to changes in the demand for labor. Knowledge that cuts in wage rates would cause a leftward shift in the labor supply curve helps keep wages during depressions at a level where supply exceeds demand. On the other hand, during periods of expansion a rise in the demand for labor soon causes the supply curve of labor to shift. The spread of trade unionism undoubtedly makes the supply price of labor more responsive than ever to advances in the demand for labor.

During a period of expansion, the supply prices of labor may change promptly or tardily after the demand for labor rises and it may rise at the same rate as the demand for labor or at a faster rate or a slower rate.[1] The effect of changes in the sup-

[1] I omit a fourth case—the supply price of labor falling while the demand for labor is rising. As I have indicated above, this relationship seems to prevail only for a brief period in the beginning of recovery from depression.

ply price of labor upon commodity prices must not be expected to be the same in these three cases. One possibility is that wages do not increase at all in response to a rise in the demand for labor. Whether the resulting change in the wage-price relationship produces a further rise in expenditures and in prices depends upon whether the original rise in prices relative to wages increases the investment opportunities associated with different levels of national income more than it increases the propensity to save—in other words, whether it produces a greater shift in the investment function than in the saving function. If it increases investment opportunities more than the propensity to save, the rise in expenditures and prices will continue. *Eventually* the rise in profits per dollar of sales, and hence total profits, will cause investment-seeking funds to increase as fast as investment opportunities. At that point the rise in prices relative to wages will cease to generate further increases in prices.

Another possibility is that wages may rise instantly and at the same rate as prices. This would prevent a rise in employment but would preserve the wage-price relationships which permitted the original rise in prices; hence the advance in spending, prices and wages will continue until halted by the limited supply of money and the rise in interest rates or by extraneous events.

Between these two extremes are various other possibilities—wages advancing (1) with a lag of varying amounts and (2) at various rates. If wages rise only slightly less rapidly than prices, the advance in prices may have to go quite far before the widening margin between costs and prices eventually checks the rise by causing investment-seeking funds to grow as fast as investment opportunities. A lag of wages behind prices may be expected to produce an expansion of credit—both because it causes investment opportunities to grow faster than savings and because it improves the credit standing of enterprises. Some particular lag of wages behind prices will be most inflationary of all because it will produce the most rapid expansion of credit and hence the most rapid rise in prices.[2] The rate of credit

[2] A faster rise of wages would discourage the expansion of credit by impairing the credit standing of enterprises; a slower rise in wages would discourage credit expansion by making enterprises better able to plow back earnings or to obtain funds by the sale of securities to individuals.

increase which produces the most *rapid* rise in prices will not necessarily produce the *greatest* rise. Until more is known about these matters, economics will be able to offer very limited information about the inflationary effects of wage changes.

III

What about wage-price relationships during the last two and a half years since V-J Day? During most of this period, prices were rising moderately faster than wages. The lag of wages behind prices between 1945 and 1947 may be related to the fact that between 1940 and 1945 wages rose more rapidly than prices. At any rate, between 1945 and 1947, for example, hourly earnings in manufacturing increased by less than 19 per cent, whereas the consumer price index increased by over 23 per cent and the wholesale price level of finished goods by almost 43 per cent. Perhaps I should add that, if one breaks up the period into parts, the relationship between wages and prices is not uniform—part of the time wages were rising more than prices and part of the time prices were rising faster than wages.[3]

There are four principal observations to be made about wages and prices during the last two and a half years.

1. The wage increases of the period have affected prices mainly as a source of demand rather than as costs. This is true despite the fact that the break-even point in many industries is far higher than before the war. Evidence that wage increases have affected prices more as demand than as costs is found in the absence of a close relationship between the wage increases in different industries and the advances in the prices of their products. For example, the prices of agricultural products, which represent less wage cost than most other prices, rose quite as much as other prices.

2. Less than half of the increase in the demand for consumer goods during the last two years has been caused by higher wages in private industry. For example, between 1945 and 1947, wage

[3] By six months' periods the percentage rise in hourly earnings of factory workers and prices was as follows:

	Hourly earnings of factory workers	Consumer prices	Retail prices	All nonfarm and nonfood wholesale prices	All wholesale prices
Jan.-June 1946	8.0	2.6	3.2	4.8	5.4
June-Dec. 1946	5.9	15.0	16.9	18.1	24.8
Dec. 1946-June 1947	6.8	2.5	3.5	5.4	4.8
June-Dec. 1947 ...	4.2	6.3	5.4	10.1	10.3

and salary payments in private industry (less contributions for social security) rose by about $14.8 billion, and personal consumption expenditures increased by $20.7 billion. About $5.3 billion of the increase in payrolls in private industries was the result of the growth of the labor force, leaving about $9.5 billion, or 45 per cent, attributable to higher wages. The fact that higher wages account for less than half of the rise in prices between 1945 and 1947 indicates the importance of other inflationary influences. One of these other influences was the tendency of people to save only a declining proportion of their rising incomes; another was that holdings of cash and demand deposits were high in relation to prices and expenditures.

3. A remarkable feature of recent wage movements is that they have indirectly helped to bring about a rise in the profits of industry. They have done this by causing the volume of spending to increase more than payrolls. The growth in the volume of spending is a result of the fact that under present conditions wage advances have not diminished employment in the capital goods industries. Hence they have increased the profits of agriculture and of the consumer goods industries. The demand for the products of these industries advanced by the amount of the rise in payrolls in *all* industries (including the capital goods industries) less the additional taxes and savings of the workers. The wage costs of the consumer goods industries, however, rose by only the amount of the wage increases given to their own employees. Since the growth of payrolls in the capital goods industries exceeded the higher taxes and savings associated with the wage advances in all industries, the demand for the products of agriculture and the consumer goods industries advanced by more than the increase in their wage bills. The greater profits of agriculture and the consumer goods industries have increased the demand of these industries for equipment and plant. In this way wage advances have indirectly raised the demand for capital goods and the profits of the capital goods industries. Trade unions criticize the recent rise in profits without realizing that under present conditions union wage policies have helped to push up profits. Likewise, business men criticize union wage policies without realizing that these wage policies under present conditions have helped industry make more money.

4. Another feature of the last two and a half years has been the contrast between the real and the apparent bargaining power

of trade unions. The period has been one of full employment and acute labor shortages; hence, trade unions have *apparently* been in a strong bargaining position. They could tie up plants effectively and they could win strikes. And yet wages have failed to keep pace with prices. The fact that employment was full and that there was a huge backlog of unsatisfied demand made it easy for employers to follow each round of wage increases with a new round of price increases; hence, unions *really* had much less bargaining power than they *seemed* to possess.

IV

The large increase in profits during the last year is being used by unions as a basis for demanding a third round of wage increases. Unions argue that employers can afford to raise wages without raising prices. The union demand and supporting argument raise several important questions such as: (1) are profits excessive; (2) would basing wage increases in different industries upon profits be in the public interest; and (3) can unions under present conditions raise the general wage level without producing offsetting increases in prices?

1. Profits in a few industries have been very large but profits in industry as a whole have not been excessive. The test of the adequacy of profits must always be the practical test of the market: are profits large enough to permit industry to attract adequate amounts of equity capital? In attracting equity capital, inventory profits do not count—the prospective investor wishes to know what operating profits the enterprise can earn. Nor is he interested in what rates present profits yield on plant and equipment bought at pre-war prices. He wishes to know what return present prices and costs make possible on new and up-to-date plant constructed at present prices. Measured by this test present profits in most industries are too small—they do not permit enterprises to attract venture capital. As a result, two thirds of the funds used by industry to expand its capital in 1947 came from plowed-back earnings. Additional money was obtained by borrowing from commercial banks. If the wage increases of 1948 encroach upon profits, industry will have to reduce the present rate of net private domestic capital formation, which is not high (less than 10 per cent of the net national product), or resort to inflationary methods of financing it. Hence it is important in most industries for enterprises to maintain their

ability to plow back earnings by raising prices (if demand permits) to offset wage increases. Price advances to offset wage increases are particularly important in the steel industry, which needs to make large new capital investments and which has only limited ability to attract capital from the outside.

2. Basing wage increases in different industries upon the increase in profits in those industries would not necessarily be in the public interest. A large rise in profits ordinarily indicates a high demand for the product of the industry and need to expand the capacity of the industry. Some increase in wages may be required to attract additional workers into the expanding industry. If wages were raised to absorb the *entire* increase in profits, however, expansion of the industry would be checked, partly because the ability of the industry both to attract outside capital and to plow back earnings would be limited and partly because the advance in costs would keep the price of the product high and limit sales. The response of wages to increases in profits in expanding industries determines to what extent the gains of technological progress are distributed in the form of higher money wages and to what extent in the form of lower prices. I shall not discuss this issue here.

3. Can unions under present conditions raise wages without producing offsetting increases in prices? Probably not. If wage increases occurred only more or less at the expense of other incomes, unions could, of course, raise wages more than prices. Present conditions, however, are unusual. Industry has huge accumulated needs for plant and equipment. Hence a rise in wages under present conditions will not produce a drop in investment expenditures. Consequently, a general advance in wages is almost certain to increase the profits of the consumer goods industries. Expenditures on consumer goods will rise by the total amount of wage increases less the increased tax payments and the increased savings of wage-earners, but the costs of the consumer goods industries will advance only by their own share of the general wage increase. So long as wage payments in the capital goods industries rise by more than the increased taxes and increased savings of all wage-earners, the profits of the consumer goods industries will rise. The advance in the profits of the consumer goods industries will stimulate the demand for capital goods.

Another difficulty arises from the fact that prices are still low in relation to bank deposits and cash. So long as this situation exists there is a tendency for each round of expenditures to be higher than the previous one. Under present conditions wage increases probably accentuate the tendency for individuals to spend more than their incomes. So long as this is true, employees cannot expect to catch up with the rising cost of living by obtaining wage increases. Eventually, of course, prices will become so high relative to holdings of cash and bank deposits that individuals will be unwilling to make each round of expenditures a little higher than their previous incomes. When this occurs, trade unions will be able to put up wages faster than the cost of living—but they may do so, of course, at the cost of producing some unemployment.

V

Some time within the next few years there may be a sharp rise in the propensity to save. This increase would be a natural result of catching up on the needs for consumer goods which accumulated during the war and early post-war years. After people have neglected for several years to provide for their future security, they may suddenly become quite interested in increasing their savings. About the same time that individuals raise their disposition to save, the demand by business for investment-seeking funds may drop because enterprises will have met a good part of their accumulated needs. The increased propensity of individuals to save will be offset in large part by a drop in corporate saving which is now very large, but the offset may not be complete.

A substantial rise in the propensity of individuals to save, coinciding with a drop in the demand for investment-seeking funds by corporations, could produce a substantial contraction in output and employment. If trade unions were to push up wage rates during the early period of the contraction (as they did in the building industry and the printing industry for a year or two after the break in 1929), the downward spiral would be made more severe. A rise in wages relative to prices extinguishes all investment opportunities before it stops all saving. Hence, as costs approach close to prices, the investment function shifts more than the saving function.

VI

What about the immediate outlook for wages and prices? Sometime within the next year the danger of a disorderly rise in prices is likely to become quite acute. The reason is threefold. In the first place, bad relations with Russia and the demands of the nations of western Europe for military assurances are about to compel the United States to increase substantially its expenditures on armaments. It is impossible to forecast the size of the increase, but it is likely to be as much as $5 billion a year and possibly much larger. In the second place, the increase in expenditures comes when the economy is already producing at capacity and when the backlog of demand which accumulated during the war has been far from satisfied. In the third place, the country is tired of direct controls of materials, wages and prices and is not prepared to support them. The possible indirect controls are weak and the public is not even prepared to give strong support to their use.

One way of visualizing the effect of an additional outlay of $5 billion on armaments is to ask what would have happened in 1947 if the federal government had stepped up its expenditures by $5 billion. The problem of preventing a disorderly rise in wages and prices, however, must be considered in terms of present conditions. Fortunately, there are several important favorable factors. One is that the capacity of the economy to produce is greater than a year ago. During 1947, business spent $15.7 billion on new plant and equipment—a fairly large amount by pre-war standards. These large expenditures should help raise output per man-hour. Unfortunately, only limited progress has been made in reducing some of the most serious bottlenecks, such as steel capacity. It looks, however, as if the country were able to produce about 4 per cent more steel ingots than a year ago. A second favorable factor is the rise in productive capacity abroad. Each month sees imports into the United States larger than imports of the same month last year. Unless contemplated expenditures under the Marshall Plan are raised, this excess of exports over imports will be $2 billion or $3 billion less than last year. A third favorable factor is that some progress has been made during the last two years in meeting the huge demand that accumulated during the war. A fourth favorable factor is that the rate of saving, though apparently

still declining, has become so low that much additional drop is unlikely. A fifth favorable factor is that the third round of wage increases of this year seems to be running slightly smaller than the second round of last year. This, however, may not continue to be true.

Some of the favorable factors which I have mentioned are of limited importance. For example, although backlogs of demand have been reduced, the accumulated needs of individuals and business concerns are enormous. Likewise, there is little comfort in the fact that the third round of wage increases may be slightly smaller than the second. The unfavorable factors are formidable. To begin with, the economy is already producing at capacity and this capacity can be enlarged only slowly. For example, the civilian labor force in February 1948 was about 1.6 million larger than a year ago. This means that the prospect of enlarging production by inducing more people to enter the labor force is much less favorable than a year ago. In the second place, the economy has lost a control which may be much needed this year—namely, control over the use of consumer credit. Credit used to finance consumption is extremely inflationary. As the output of automobiles and other durable consumer goods rises, this use of credit is likely to increase. In the third place, the cash budget surplus, on the basis of the President's budget proposals, will be somewhat smaller than last year—perhaps about $6 billion in comparison with $7.8 billion last year. This estimate assumes that cash receipts are $3 billion above the President's estimates and it takes account of the recent tax reduction and of the proposed federal expenditures under the Marshall Plan. It does not, however, allow for any increase in military expenditures beyond those recommended by the President; hence a rise of $5 billion in military expenditures would almost wipe out the cash surplus.

What should be done? Let us be frank. A large rearmament program, started from full employment, really requires many direct controls. Can the automobile industry, for example, expect to make cars without limit when the country is acutely short of steel and gasoline? Honesty, however, compels one to concede that the people of the United States are not prepared for the reimposition of direct controls. If the country pursues a large rearmament program for any period of time, direct con-

trols will undoubtedly be necessary. It would be a mistake, however, to impose them before the need has become clear. For the time being, therefore, the country must do the best it can with indirect controls and let experience slowly demonstrate the necessity for additional steps. What indirect controls are available?

1. Increase production as rapidly as possible. The steel industry added nearly 3 million tons of ingot capacity during 1948. It also reduced two bottlenecks by adding 1.7 million tons of blast furnace capacity and 2.2 million tons of coke capacity. Even larger increases in blast furnace and coke oven capacity are planned for 1948, but additions to ingot capacity will be only about one million tons. Industrial production as a whole may average between 7 and 8 per cent above 1947.

2. Arrange to obtain considerably more steel output from the Ruhr. Present plans contemplate restoring production to only about two thirds of pre-war levels. Output should be restored to pre-war levels and Ruhr steel should be used to help meet the needs of the United States. Not only could steel and steel products from the Ruhr help rearm the United States but they would reduce Europe's trade deficit with this country and help to cut the cost of the Marshall Plan. Immediate restoration of Ruhr output to pre-war levels is not practicable, but within two years Ruhr production would make a substantial contribution to meeting the needs of the United States.

3. Restrict the use of inflationary methods of financing production and consumption. More output does not cure inflation if it is financed by inflationary methods. Particularly inflationary, of course, is the use of credit in financing consumption. One of the immediate steps called for is restoration of the control of the Federal Reserve Banks over consumer credit. Important also is tighter control of lending for housing construction. Finally, the expansion of private bank credit needs to be vigorously combated by Federal Reserve and Treasury policies so long as industry is operating at capacity. Every specific suggestion meets vigorous objection from within the Reserve System. Consequently, I think that the time has come for the public simply to make plain that it expects private bank credit to be prevented from expanding faster than production and to let the Reserve authorities decide how to carry out this mandate.

The public should make plain also that it expects other kinds of inflationary operations, such as sales of government bonds by insurance companies and others to the Reserve Banks, to be offset.

4. Make every effort to keep wage increases down to moderate amounts. Many union leaders privately admit that wage increases under present conditions merely help to maintain inflationary pressures. Since Congress has just made an inflationary reduction in taxes, it will not be easy to insist that unions act in a farsighted and statesmanlike manner. If unions push up wages, is it practicable to insist that private bank credit shall not be expanded faster than production? The answer to this question depends upon what is done to encourage personal and corporate saving.

5. Develop a well-planned program to increase the volume of savings in the community. The need for more saving has been obvious for some time. Industry is grievously short of plant and equipment. Nevertheless, the large increase in incomes which occurred during the last year has been accompanied by a drop rather than a rise in saving. The stiff progressive income tax has gradually reduced the willingness and ability of individuals to save—especially the individuals who can best afford to take chances. As a result of the low rate of saving, about two thirds of the new money which went into corporate industry in 1947 came from plowed-back earnings. Additional amounts were obtained by borrowing from the banks. Effective checks on the expansion of private bank credit can hardly be maintained unless there is a substantial rise in savings.

The government might well adopt as a target raising personal savings to 10 per cent of disposable income. This was the rate which prevailed in the second quarter of 1946. In the year 1941, personal savings were 10.7 per cent of disposable income. In the last quarter of 1947, however, personal savings were only 6 per cent of disposable income. A rise to 10 per cent would increase the annual rate of saving by about $7 billion.

Efforts to increase savings should take two principal forms. One is larger sales of government savings bonds. The record of savings bond sales during the past two years has been surprisingly good. Nevertheless, a difficult problem confronts the Treasury because persons who bought government bonds during

the war, and even as late as the early part of 1946, have suffered a heavy loss in the purchasing power of their principal. People may properly be asked to buy government savings bonds as a patriotic duty—on the ground that they are making a much smaller sacrifice than the thousands of young men who are required in a period of emergency to serve in the armed forces. After the government's demonstrated incapacity to control prices, however, the Treasury cannot properly represent the present type of government savings bonds as a suitable investment for persons who need to conserve the purchasing power of their principal. The time has probably come for the Treasury to offer a savings bond which is payable in a fixed amount of purchasing power. In order to protect the savings banks, the individual purchases of the new type of bond should probably be limited, say, to $2,000 a year.

The second part of the savings program should be permission for individuals to claim a substantial rebate (say one third) in the income tax on that part of their incomes which they save. Such an arrangement is particularly important because of the adverse effect of the stiff progressive income tax upon savings and upon the willingness of investors to take chances. Under present conditions, however, an unqualified reduction in the income tax would be inflationary because the accumulated demand for consumer goods is still enormous.

6. Adopt a moderate forced saving levy. This may not be necessary until next fall—the time will be determined by the rate at which armament orders are placed (not the rate at which the goods are paid for). A forced saving levy is preferable to increased taxes on corporations. Since corporations are heavily dependent upon plowed-back earnings for financing the purchase of capital goods, heavier corporation taxes would aggravate the difficulties of controlling the expansion of bank credit. Since income taxes, even after the recent reduction, are still high, a forced saving levy is preferable to higher income tax rates. The forced saving levy should take the form of non-negotiable savings bonds running for three years. Since the levy is a forced one, the interest yield should be high, say 6 per cent and tax exempt.

7. Adopt the policy that government deficits which may result from rearmament and aid to Europe shall be financed by

sales of government securities to nonbank buyers. This policy also requires that the government give relief in the form of a tax rebate on the part of incomes which are saved.

VII

What about the long-run movements of wages and prices and the relationship between them? The rise of collective bargaining and of powerful trade unions may be expected to produce a slow upward movement of prices. The consequences of this have been quite generally overlooked but they will be tremendous.

During the last hundred years the movement of prices has been more or less horizontal. The index of wholesale prices rose slightly, but the real price level undoubtedly fell by a moderate amount.[4] The long-run movement of the price of labor, as measured by hourly earnings, has been sharply upward. In 1940, the hourly earnings of nonagricultural workers in the United States were about eight times as large as in 1840. This rapid rise in hourly earnings occurred during a period when unions, on the whole, were small and weak. Today, two thirds of the workers in manufacturing, four fifths in transportation, four fifths in construction, and four fifths in mining are organized. The rise of unions has created a new type of economy—an economy in which the supply price of labor responds far more readily than ever before to increases in the demand for labor and in which, indeed, the supply price of labor may rise quite independently of the demand for labor.

Experience indicates that the engineers and managers are not likely to raise output per man-hour faster than 3 or 4 per cent a year. People who do not expect the long-term movement of prices to be upward are compelled to argue that unions will be content not to increase wages faster than the engineers and managers advance output per man-hour. That, in my judgment, is an unrealistic assumption. Unions are far more likely to force up wages faster than the engineers and managers raise output per man-hour—perhaps 2 per cent or 3 per cent a year faster, perhaps even more.

The difference between the rise in money wages and the rise in output per man-hour will have to be compensated by an ad-

[4] The index has an upward bias because it does not promptly give representation to new articles and does not take full account of improvements in quality.

vance in prices. For example, if output rises by 3 per cent a year and money wages by 5 per cent a year, prices will need to rise by about 2 per cent a year. Otherwise, there will be a creeping increase in unemployment until the unions are no longer able to raise wages faster than the engineers and managers can raise output. Perhaps the necessary advance in prices will occur without stimulation by public policy. If it does not, the government will be compelled either to check the rise in money wages or to encourage a rise in prices. The first policy of the government, one may safely assert, would be to encourage an advance in prices.

A rise in prices of 2 per cent a year seems small, but it would make a profound difference in the course of a generation. Pensions or life insurance, which men started to buy on entering the labor force at about the age of twenty or twenty-five, would have lost more than half of their purchasing power by the time the workers had reached the age of sixty-five or seventy. And with prices rising 2 per cent or 3 per cent a year, who would wish to own government bonds yielding 2½ per cent? All fixed-income securities would have to sell at yields which discounted the expected drop in the purchasing power of the principal. What would happen to life insurance or pensions is difficult to say. Certainly it is doubtful whether private companies could offer the kind of life insurance and pensions which would be attractive in an economy of steadily rising prices. Since the demand for life insurance and pensions is strong, perhaps the government would have to assume the responsibility of providing life insurance and pensions.

VIII

When I say that prices would need to rise fast enough to offset the tendency for money wages to rise faster than output per man-hour, I am asserting that the unions are likely to become the real makers of credit policy and possibly, in large part, of fiscal policy as well. No government will assume the responsibility of creating unemployment in order to limit the bargaining power of unions. That raises this basic question: will the community permit the movement of wages and prices to be determined by tens of thousands of bargains between unions and employers or will it adopt a national wage policy and require that collective bargains conform to it?

This question is faced today in one form or other by Britain, Sweden, Norway, France, and other countries where collective bargaining has become fairly universal and where the wage policies of unions threaten to defeat the efforts of the government to control prices. In these four countries the conflict between free trade unionism and national planning has become plain. In Norway free trade unionism has been rather easily reconciled with national policy-making. Two conditions have helped bring about this result: (1) the Labor party is in power and (2) the trade-union movement has a strong tradition of centralization. For these reasons, the unions did not feel that they were giving up much when they subordinated their wage policies to a national plan.[5] In England, the problem has been more difficult. Although the Labor party is in power, the trade-union movement has strong traditions of autonomy for the individual unions. Nevertheless, the necessities of the country are so compelling that national planning seems slowly to be winning over free trade unionism. In France, the government is weak and fails to command the support of a large part of labor. Hence the trade unions have been unwilling to accept the policies of the government and have thus far been fairly successful in imposing their will on the government.

The United States is not yet prepared to recognize that there may be important conflicts between national policy-making and free collective bargaining. And yet the United States is gradually going through experiences which raise again and again the same question: to what extent can the country permit the structure of wages and the movement of wages to be set by the method of thousands of bargains between unions and employers? Does this method of wage-fixing take sufficient account of national interests so that the community can tolerate it only within the framework of a national policy?

Recent experience with the effect of union wage policies on prices illustrates the issue. The matter will be even plainer after fifteen or twenty years of collective bargaining. Tens of millions of people are likely then to see rising prices slowly reducing the value of their savings, pensions, bonds, life insurance, and mortgages. Hence, the community may endeavor to make

[5] The experience of Norway is discussed at length in a forthcoming book on industrial relations in Norway by Walter Galenson of Harvard University.

wages the subject of a national policy. The stronger unions will resist this development and they will be aided by the tradition of the labor movement which has always strongly opposed government interference with union activities. The stronger unions will probably be assisted in their opposition by a considerable part of the business community which would prefer to make concessions to unions rather than be regulated by the government.

Two conditions will increase the probability that a national wage policy will be developed to guide the operation of collective bargaining. One is the possibility that a national wage policy will be supported by the weaker unions. When collective bargaining is more or less universal, the real bargains are not between unions on the one hand and employers on the other, but between unions in the various industries and occupations. Naturally, the stronger unions are able to raise their standard of living at the expense of the weaker unions. A national wage policy would tend to protect the weaker unions from the stronger. The second condition that will increase the probability of a national wage policy is the fact that over three out of four workers are employees. Hence, the government will be increasingly sympathetic to labor, and the influence of labor in politics will steadily increase. Experience shows that governments which command the confidence of labor are most effective in regulating the activities of trade unions.

Great changes in the distribution of power cannot occur without changing people's ideas about rights, duties and public policies. Certainly the spread of collective bargaining and the shift of power between employers and unions will bring about changes in the ideas of the community about the rights and duties of employers and unions and the way in which collective bargaining should be conducted. Hence, the very spread of collective bargaining means that the country stands on the threshold of major developments in its economic institutions and public policies. One cannot predict with precision what these changes will be, but one is safe in asserting that thinking about industrial relations will place less and less emphasis on the rights of small groups of employers and workers and more and more emphasis on the problem of protecting the interests of the community as a whole.

Remarks by the Chairman

Chairman Morgan: I would call your attention to one remarkable thing in the speech that we have just heard. Professor Slichter has spoken with complete independence. I counted five or six, possibly more, segments of the community whose tender spots he touched, but he did it with such good nature that even those whose tender spots were touched had no complaint. That is a remarkable thing; it is exactly what the Academy wants from its speakers; it is entirely consistent with the unique American principle of free speech which more and more in the world is coming into question.

I wonder if Mr. Shishkin is in the audience. He is our third speaker this afternoon, but I have not seen him come in. Then suppose we go to the final stage in our program, with a possibility that we may have a chance to hear Mr. Shishkin a few minutes later. His plane may be cruising in the air somewhere trying to find a hole through the mist in order to get into a landing field. In any case, I know he would have come if he could.*

* Unfortunately, because of circumstances beyond his control, Mr. Shishkin was not able to participate in the session.—Ed.

PART III

PRICES, WAGES AND INFLATION

INTRODUCTION *

RUSSELL C. LEFFINGWELL, *Presiding*
Chairman of the Board, J. P. Morgan & Co., Incorporated

MR. MINISTER, Mr. Secretary, honored guests, members and friends of the Academy:

I have to take, though I cannot fill, the place of the Academy's distinguished president, Mr. Lewis Douglas, whose duties in the service of our country prevent him from being with us. I like to do what Miss Ethel Warner wants. She has served, and directed, the Academy so ably and devotedly; and she is a hard woman to say no to. I know that my dear friend and partner, Mr. Thomas W. Lamont, to whom so fine a tribute was paid in the March number of the Political Science Quarterly, would have wanted me to do it. He was a great and devoted believer in the Academy.

I am reminded, by the Under Secretary's presence, of the day nearly thirty-one years ago when, almost at the door of Plattsburg, I was summoned to the Treasury at Washington and told by Secretary McAdoo to go off with Mr. Broughton, the able Chief of the Division of Loans and Currency, and write a circular for the First Liberty Loan. The loan bore 3½ per cent interest fully tax exempt, and was for $2 billion. The ablest bankers thought that no such amount could be sold! They were wrong. We in the Treasury wrote the circular, but Arthur Anderson and the Liberty Loan Committees sold the bonds.

* Opening remarks at the Third Session of the Semi-Annual Meeting.

The next thing to do was to set up the machinery for depositing the proceeds of the loan among all the banks of the country pro rata to the subscriptions made through them. No such machinery had ever existed before. Treasury deposits had previously been made by the Secretary of the Treasury according to his judgment or whim. With the aid of a distinguished committee, consisting of James Alexander of the Bank of Commerce, George Davison of the Central Hanover, and Jerome Hanauer of Kuhn, Loeb & Co., the automatic and equitable machinery was then created which, with appropriate modifications, has been used ever since.

For that First Liberty Loan provision had to be made to secure the government's deposits by the pledge of miscellaneous bond and commercial paper, for there were no government bonds then to speak of. The total government debt upon our entrance into the war in 1917 was only about \$1¼ billion. It grew to be \$26½ billion at the peak in 1919. Now our government's annual budget is 1½ times that.

Treasury methods were different in those days. Fiscal fashions change like the length of women's skirts or the width of their shoulders. The Treasury was severely criticized for not paying high enough rates of interest, though the rates on Liberty Loans rose from 3½ per cent to 4¾ per cent. Now as you know the highest rate is 2½ per cent.

When the Second Liberty Loan came, the Treasury persuaded Congress, not without difficulty, for the first time in American history, to issue taxable bonds. The bonds were subject, with minor exceptions, to income surtaxes and to excess profits taxes. From that time forward fully exempt United States bonds have not been issued, though some of the Fifth or Victory Loan notes were issued fully exempt.

In those days the Treasury shunned the practice of direct borrowing from the Federal Reserve Banks, although persons and corporations were encouraged to borrow from their banks to buy Liberty Bonds, and the banks in turn borrowed from the Federal Reserve. The reverse policy was followed by the Treasury in the Second World War, when borrowing to buy bonds was discouraged, while direct borrowing by the Treasury from the banks, and Federal Reserve open market purchases, were a matter of course.

In the First War the Treasury never pegged the price of its bonds, though the War Finance Corporation and the Bond Purchase Fund supported them to some extent, without pegging. Nowadays pegging is the regular practice.

When the First War was over and inflation was rampant, the Treasury and the Federal Reserve coöperated in applying the classical method of inflation control, and the Federal Reserve Bank rate was raised to 6 per cent and then to 7 per cent in 1920. My last act before I retired from the Treasury at the end of June 1920 was to issue a 6 per cent one-year certificate of indebtedness. Dear money resulted in drastic deflation.

Now, the rate on certificates is 1⅛ per cent, and the Treasury and the Federal Reserve are keeping money very cheap by Federal Reserve bond buying when necessary. This is not the occasion for me to discuss that policy.

The first time I ever spoke to the Academy of Political Science was in the spring of 1920 when I addressed the Academy on " Treasury Methods of Financing the War in Relation to Inflation ". Now again inflation is a problem.

Both the First World War and the Second World War were well financed, and inflation was on the whole well controlled during the wars. Methods were different, but in both wars a great effort was made, a great public-spirited, nation-wide effort was made, to avoid avoidable inflation. The only fundamental differences arose after the wars, the difference between dear money then and cheap money now.

It has been suggested that a pay-as-you-go policy be adopted, if a Third World War comes, which God forbid. Now the truth is that a pay-as-you-go policy in war is not a practical policy. Economically speaking, war is the business of destruction. To engage in the business of destruction prudently and conservatively, avoiding any greater government expenditure than the taxpayers of the country can meet out of current taxes, means that we shall send our sons and grandsons to war with bare fists, and lose the war, prudently, with a balanced budget and a dear-money policy; and leave it to our conquerors to inflate us. It is a doctrine of unutterable nonsense. What must be done, and what was done in both wars, is to raise taxes as high as, in the judgment of Congress and the Treasury, they can be raised, consistently with maximum production for the

conduct of the war, and to sell as many bonds as possible to the people. War is economic waste. The consequent inflation represents the difference between the government's necessary expenditures for the conduct of the war and the current savings of the people collected by the government in taxes and war loans.

Our first speaker is a distinguished business man, newspaper publisher and banker from South Carolina, who is greatly honored among the bankers of the United States and is a former president of the American Bankers Association. I have the honor to present to you Mr. Lee Wiggins, the Under Secretary of the Treasury of the United States. (Applause)

REMARKS

MR. A. L. M. WIGGINS: Mr. Chairman, Mr. Minister, Members of the Academy, Ladies and Gentlemen: I must admit in all frankness that I have been brought here tonight under a serious misapprehension. I have been directed, almost commanded, to prepare the most learned address that it was possible for me to prepare, because I would find an audience of economists, college professors and learned people who would not appreciate my usual type of public speaking, which includes a lot of Southern stories. On looking around, however, I observe many friends of former days, who would much prefer those stories to the so-called learned address that I am now about to deliver.

I want to say that I am also embarrassed by a casual statement of the distinguished Minister of Finance from Canada who has just informed me of the surplus in the Canadian Treasury at the close of business and the close of the fiscal year today which relatively is twice the amount that we hope to have as a surplus on June 30 next. As a matter of fact, I am now planning to go to Canada to find out how they get so much more money, relatively, than we are able to get when we think that we have looked into almost all revenue sources in this country.

As a representative of the Treasury Department, I would like to talk about fiscal policy and debt management. I brought along an extra copy of my talk to give to the Finance Minister of Canada, but instead of that, I am asking him to leave with me a copy of his address.

FISCAL POLICY AND DEBT MANAGEMENT

A. L. M. Wiggins
Under Secretary of the Treasury

My discussion tonight will be devoted primarily to debt management as a part of fiscal policy. Over-all fiscal policy is concerned with the desirable amount and sources of government revenue and the amount and uses of expenditures of the federal government, on the basis not only of financial but of economic considerations as well.

In actual practice, however, the amount of receipts is often determined as much by a consideration of what it is feasible to collect as it is by a broad consideration of consumer and business incomes and the amount of goods available for purchase. The total amount of the federal government's expenditures is often determined by other than economic considerations. Our huge war expenditures were made in order to win the war and not because the economy needed them; and this is also true of the proposed expenditures for the European Recovery Program.

It was not deemed feasible or desirable for total receipts during the war years to equal total expenditures. On the other hand, when national income and production are high, employment full, and inflationary pressures strong, economic considerations should control, so as to produce a budget surplus that may be applied toward economic stability and debt reduction.

The determination of the total amounts and the balance of receipts and expenditures of the federal government that is most conducive to a healthy domestic economy should be the basic consideration of fiscal policy in peacetime.

The condition of the American economy since V-J Day indicated a fiscal policy of seeking to keep expenditures as low as compatible with the discharge of our domestic and international obligations and of seeking to keep receipts as high as is consistent with a vigorously functioning private-enterprise economy and a reasonable untaxed minimum standard of living for persons in the lower income brackets. These objectives continue to call

for the maintenance of the present aggregate level of federal tax revenues.

We would be blind to the stern realities of the hour if we failed to recognize that rapidly changing world events are generating new variables and new problems which will have a profound effect on our entire national economy and on fiscal policy. The limits of my time, however, do not permit a discussion of tax policy and questions of expenditures as basic elements in the determination of fiscal policies. I shall limit my discussion to the area of public debt management.

The number one constant in the equation of debt management is a present federal debt in excess of $250 billion. The importance of this debt is not merely its size but its proportion to the total of all debt, the impact of its management on all interest rates, the cost of servicing the debt, and proper provision for its retirement.

In the 1920's, the public debt, federal and state and local, amounted to a little over $30 billion and was less than 20 per cent of the total of all public and private debt. Today, the total public debt, federal, state and local, is about $270 billion and constitutes some 60 per cent of the total of all debt. In the 1920's, government securities constituted about 12 per cent of the total assets of member banks; while today they constitute about 50 per cent of total assets. In the 1920's, the rate of interest on the public debt was influenced largely by current financial and business conditions and the rate on private debt; whereas today, the size and the proportion of the federal debt to the total of all debt make it the dominating factor in determining interest rates on private debt and the return on investments. In the 1920's, the public debt was only about three eighths of a year's gross national product; whereas, in 1947, the public debt exceeded the gross national product for the year.

These figures and comparisons are unmistakable evidence of the importance of public debt management and of the compelling necessity for such management to be directed not merely to the financial considerations of government itself, as important as they may be, but to the effect of such management on our entire economy. No matter how jealous we may be of the freedoms of private enterprise, nor how abhorrent to our concept of such freedom that control and management by central

government may be, the hard facts are that the management of our large public debt is such a dominant factor in the financial and economic life of the nation that it is imperative that firm control of debt management be exercised by the federal government. This must continue as long as the public debt continues at its present relative size and proportions. Financial and business leadership should be constantly alert, however, and fully coöperative in seeing that the exercise of that power is, at all times, directed toward the broad objective of the national welfare.

In February 1946, at the highest point, the total federal debt, direct and guaranteed, was $280 billion. Cash balances of the Treasury amounted to $26 billion. The wartime interest pattern of the debt ranged from ⅜ of one per cent on 90-day Treasury bills to 2½ per cent on long-term Treasury bonds. The distribution of the debt was $117 billion held by the commercial banking system, $65 billion held by individuals, $28 billion held in government trust accounts, and $70 billion held by other investors. For the remaining months of the fiscal year, to June 30, 1946, there was a further deficit in the federal budget of over $1½ billion. There was a growing inflationary pressure in our economy.

With these factors, the correct policy of debt management was clear. It was to utilize the excess cash balance beyond budget needs for the retirement of the debt. The proper place for such retirement was in the commercial banking field. This policy was followed, with the result that by the end of December 1946, when cash balances had been brought down to a peacetime working level, the total debt had been reduced by over $20 billion, of which $19 billion were taken out of the commercial banking system.

We then moved into the second phase of post-war debt management. From January 1, 1947 through June 30, 1947, there was a budget surplus of approximately $¾ billion. This represented the reduction of the public debt which it was possible to achieve during this six-month period from an excess of receipts over expenditures. During this period, however, it was possible to reduce the holdings of the commercial banking system by $6 billion through the application of this surplus, through the use of the proceeds from the sale of savings bonds

to the public, and through the use of the excess of the cash operating surplus over the budget surplus. The inflationary pressures had increased during this period and, therefore, the economic objective of an anti-inflationary debt management policy was paramount.

For the fiscal year ending June 30, 1948, there is an indicated budget surplus of $7.5 billion. This surplus has been, and is being, used for debt retirement. The Treasury also will receive about $1½ billion from the net sales of savings bonds and from other sources, making a total of approximately $9 billion which will be available for the retirement of the marketable debt. During this period, inflationary pressures have continued high. Therefore, in the interest of stabilizing the economy, the use of these funds has been directed toward a reduction of bank-held debt, with particular emphasis on the retirement of debt held by the Federal Reserve Banks.

Offsetting the impact of this program to a considerable extent has been the nonbank selling of government securities to the Federal Reserve Banks and the inflow of gold. These factors have diminished the full anti-inflationary effect of the debt management policy this year. This policy has been of substantial effect on the credit structure, however, particularly on long-term interest rates of private and municipal credits, and in encouraging a greater degree of caution in the lending field.

The present budgetary surplus as of the end of March is greater than the net surplus indicated on June 30 next; but an excess of expenditures in the fourth quarter of the current fiscal year above receipts will reduce the current surplus to the $7.5 billion indicated in the budget estimates, or less. For debt management, however, the deficit for this three-month period can be more than offset with withdrawals from the government's war loan deposits in commercial banks now approximating $2 billion. These withdrawals, together with cash receipts from the sale of savings bonds and net receipts from trust funds, will be available for debt management purposes and will be used to continue the pressure on the money markets.

Throughout the current fiscal year, recognition has been given to the wartime artificiality of the low rates on short-term government securities. The task was to remove the rigidities of

these artificial wartime rates without serious disturbance to the money markets. Through the coöperation of the Treasury and the Federal Reserve System, the rates on 90-day bills were permitted to move up, beginning with the issue of July 10, 1947. Through the issue of ⅞ per cent certificates on August 1, 1947, for an eleven-month maturity, an adjustment of the certificate rate was begun. These adjustments have continued until the 90-day bill rate is now approximately 1 per cent, and the one-year certificate rate is 1⅛ per cent. The effect of these adjustments in rates has been consistent with the over-all debt management policy of the past year.

I have indicated that the budget surplus has been the most potent weapon in debt management for the anti-inflationary objective. This leads to a brief discussion of the outlook for the fiscal year ending June 30, 1949. We start with the President's budget estimate of a surplus for fiscal 1949 of $4.8 billion. In view of world conditions, we would be unrealistic if we failed to recognize the possibility that this surplus may be considerably reduced through increased expenditures. Furthermore, a tax bill has passed the Congress which, if it becomes law, will reduce the total revenues of the federal government by more than 10 per cent. Under this legislation, revenues during the fiscal year ending June 30, 1948 will be reduced by only about $600 million; but revenues for the fiscal year ending June 30, 1949 will be reduced by about $5 billion. Adding to this reduction of $5 billion the sum of $500 million, which will be paid out in additional tax refunds, the proposed tax reduction, based on present budget estimates, would convert the expected surplus of $4.8 billion into a deficit of $700 million.

Even on the earlier budget estimates, without consideration of reduced receipts that will result from the proposed tax reduction and without any consideration of increased expenditures beyond original budget estimates for military and economic preparedness, there is indicated no further budget surplus between April 1 and December 31, 1948. The next period of substantial surplus will be in the first quarter of calendar 1949.

For the full fiscal year 1949, with the currently proposed tax reduction and without any net increase in expenditures, there will be a rise in the public debt of $700 million, and the only

funds available for debt management will be the cash receipts from trust funds and the receipts from sales of savings bonds in excess of the budget deficit. If, therefore, inflationary pressures continue through fiscal 1949, and if debt management policy is to be continued with an anti-inflationary objective, the ammunition will be severely limited. Thus it is highly important in the year ahead that a maximum effort should be devoted to the sale of savings bonds to nonbank holders, so as to provide the greatest possible amount of funds to be used in maintaining reasonable pressure on the credit situation.

Recognizing the strategic value of the sale of savings bonds to individuals as a dual purpose weapon against inflation that will divert cash from the spending stream and, at the same time, provide funds which may be used in retiring bank reserves and deposits of commercial banks, the Treasury Department is instituting a new and accelerated Security Savings Bond Campaign, beginning April 15. Enthusiastic support for the program by industrial concerns, labor organizations, bankers, retailers, insurance companies, the entire advertising industry, and many others, assures an all-out effort.

I have used the President's budget estimates as the basis of all the figures I have given. Here and there, questions have been raised as to whether these estimates, in some cases, may be too low or too high. The answer is that all estimates of the future are necessarily estimates; they cannot be proved facts. They are as scientifically prepared as is possible, by as competent a group of technicians as can be assembled, and are based upon all known facts and the judgment of those in the best position to form a sound judgment in the financial field, in the business field, and in government. What the national income will be, what the personal incomes for the nation will total, what the national gross product will be between July 1, 1948 and June 30, 1949 cannot be determined by a slide rule on January 1, 1948. Yet a determination had to be made at that time of a base on which to estimate government revenues for the period six to eighteen months in advance. With a government budget equal to about 20 per cent of total personal incomes and with the government revenues determined largely by the total of such incomes, any variation in the base necessarily affects the actual

revenue receipts. With many new factors continuously arising that affect the base, the surprise is not in how much the difference is between actual receipts and estimates but how little.

Revenue estimates for the fiscal year 1949 are based on personal incomes of $200 billion for that period. This is $3 billion more than the total for the calendar year 1947 and is $11 billion less than the rate at which such income payments ran in the month of January 1948. I am fully convinced that the base of $200 billion is as realistic and as uncolored by desires or objectives as reasonable men, using all available material and the most scientific technique, can determine.

On the expenditure side, costs that are products of war and defense constitute 79 per cent of the President's budget. There are few areas in this group where expenditures may be reduced; but, on the other hand, there appear to be potentials in which substantial increases may become the price of self-preservation. In the other areas of the cost of government, the American people have shown little disposition to deny themselves services that multiply the cost of government. There are some areas in which economies may be, and are being, effected, but, so long as the American people demand of the federal government vast operations and services, subsidies and guarantees, substantial reductions in the cost of government cannot be had.

It has been suggested that, in order to improve the budget picture for fiscal 1949, the sum of $3 billion for the foreign recovery program be earmarked and charged against the 1948 budget and credited to the 1949 budget. The result is merely a bookkeeping transaction that would affect neither the time of receipt by the government of a dollar income nor the time of payment of a dollar of expenditure. From the standpoint of debt management, there would be no effect at all.

In the field of interest rates, there is but a limited area in which debt management policy can operate. Present rates on long-term government bonds are practically at the coupon level of 2½ per cent. During the months of March, April and May 1947, there was an incipient boom in the bond market with heavy pressures on the long-term rate. It was recognized, in the interest of our national economy, that it was undesirable for long-term money to become worth less and less. There was a

demand for the issuance of new government securities to meet investment demand. In order to meet this situation, the Treasury Department, over a period of six months, sold long-term bonds from some of its investment accounts to a net amount of \$1.5 billion. In September 1947, the Treasury Department offered a nonmarket G-type bond to institutional investors under a limited formula, resulting in sales of approximately \$1 billion. The effect of these operations was to take the pressure off the market and create the conditions under which prices declined and interest rates moved up. Thus was averted the boom market in long-term securities.

Following this period, the market pressures reversed themselves and there developed instead an increasing downward pressure on prices and upward pressure on rates. The 2½ per cent long-term rate was then stabilized through purchases in the market by the Treasury and the Federal Reserve Banks. At present, there appears to be a relative equilibrium in the long-term market.

It should be well recognized that there is no question of the financial adequacy of the Federal Reserve System and the Treasury to maintain the market and the rate and to buy all of the securities that may be required for that purpose. The total amount of marketable government bonds with a final maturity date of ten years or more presently outstanding is only \$64 billion out of the total debt of more than \$250 billion.

There are several considerations that argue for the maintenance of the long-term 2½ per cent rate on government securities.

Whether this rate is the correct one in terms of long-range worth of long-term money or not, it was the rate used in financing the war. That rate, and the market for securities based on that rate, and the liability of institutions that have acquired those assets based on that rate have been integrated into the financial structure of both public and private institutions throughout the nation. Commercial bank holdings of government securities are about seven times their capital funds; the holdings of government securities by mutual savings banks are about six times their reserves. The holdings of government securities by life insurance companies equal more than five times

their capital funds. The average maturity of government securities held by commercial banks is four years, by mutual savings banks is thirteen years, and by life insurance companies, fifteen years. Any rise in interest rates of government securities, with a consequent decline in market value, would create a book loss against capital funds of these institutions, multiplied by the ratio of government bonds to capital assets. A small rise in the interest rate of long-term government securities would result in a market decline of all long-term securities that would create a book loss on assets held by many such institutions equal to the total of their capital and capital reserves. While such book losses would not be actually sustained, the existence of such market valuation shrinkage in large proportions might threaten the stability of many institutions.

An aggregate of $46 billion savings bonds is held by millions of individuals. These securities bear an interest rate to maturity from 2½ per cent to 2.9 per cent. These bonds are payable upon presentation and demand. A rise in interest rates would be a wholesale invitation for cashing these bonds and would undermine the confidence of the owners in their original investment.

The interest cost to government on the public debt is $5.2 billion per year, or $100 million per week. This item represents 14 per cent of the federal budget for the fiscal year 1948. Unless there is a substantial reduction in the debt, the total interest cost will continue to rise. There are two reasons for this. One involves savings bonds. The interest rate on E Savings Bonds, if held to maturity, is 2.9 per cent, but the interest charge on these bonds is carried in the budget on the basis of the actual accrual each year. The bracket rates for accrual are graduated and they run up to 4.76 per cent. This top rate will be reached on the largest blocks of savings bonds outstanding during the next two or three fiscal years. Second, the continued accumulation of trust funds is invested, under statutory requirements, at an interest cost to the government up to 4 per cent. To the extent that these funds are used to retire short-term, low-rate securities, the interest cost on the total debt will rise. It is of considerable importance to the taxpayer that the interest cost of the debt be held to a minimum.

With interest rates on the government debt the dominant factor in influencing all interest rates, any rise in long-term rates on government securities would disturb private business in its long-term planning.

No one can predict today what the financing needs of government may be in the years ahead. To destroy the integrity of the long-term rate with which World War II was financed would multiply the difficulties in any large-scale financing that might be needed in the years ahead. Nor should we overlook the fact that, with the present debt, more than $50 billion must be refunded each year.

It has been argued that long-term interest rates should be allowed to seek their " natural " level. What is sometimes meant by the natural level is the determination made by the investment and money markets. But this use of the term " natural " adds little to the discussion, as the determinations made by the money market are, for the most part, merely reflections of the underlying credit policies of the monetary authorities.

Monetary authorities are not omnipotent, however. In the long run, there is a real natural rate of interest, and a departure from this rate will collect its own toll. The natural rate of interest in this sense is that rate which is high enough to hold down the amount of capital formation to the currently accruing savings of the economy, yet low enough to permit the savings made at a high level of employment to be fully invested.

A rate of interest that is too low will, in the long run, encourage more capital formation than can be financed by the current savings of the community. The difference will then be made up by an expansion of bank credit with a consequent upward pressure on prices sufficient to compress consumption enough to release the necessary resources.

On the other hand, an interest rate that is too high will not permit as much capital formation as the real savings of the community would make possible. As a consequence, the community will not secure the benefits of all the investments which it could otherwise have, and the labor and capital which would have gone into creating these investments will be unemployed.

It is necessary, therefore, that the monetary authorities recognize the long-run economic limitations upon their powers.

It should be fairly recognized that if selling pressures by holders of long-term bonds are offset by no substantial demand except that provided by the Federal Reserve System and the Treasury, the maintenance of the 2½ per cent long-term rate will provide no flexibility for the use of long-term rates as an important factor in credit control. This brings us back to the big constant in the equation, the size of the public debt, the cost of carrying it, its widespread ownership among millions of individual owners, and its preponderant proportion in the assets of commercial banks, savings banks, trust funds, insurance companies, and other institutions. These considerations must continue to control the determinations of public debt management policy.

In the short-term interest field, there is some greater latitude. In that area, financial and economic considerations permit a reasonable adjustment of that rate up or down as the needs develop. It is a delicate mechanism with vast potentials and should be used with great prudence and keen understanding of the effect of every move.

In conclusion, I revert to basic considerations of fiscal policy as they relate to receipts and expenditures. Broad economic considerations should have first place. It is inconceivable that we would take the risk of placing on top of the inflationary pressures growing out of the financing of the war new inflationary pressures that will grow out of deficit financing. The dangers are too great.

The alternatives are clear. We must either make up any difference between receipts and expenditures through further taxation or resort to the strait jacket of rigid controls of our economy. Even with such controls, sound fiscal policy dictates that any deficits be financed through mobilizing the savings of the country, and particularly of individuals, in so far as that is possible. If resort must be had to the banks, the borrowing should be through short-term, low-yield obligations, such as bills and certificates, which would be appropriate from the standpoint of both the cost to the government and their place in bank portfolios.

The task ahead in the administration of a sound and effective fiscal policy is not an easy one. To meet the current and the

new situations that may develop, we shall need skill and wisdom and courage. More than that, we shall need restraint on the part of the business and banking community, on the part of labor, on the part of government, and on the part of the consuming public. We will need and should seek Divine guidance.

In our efforts to provide economic stability at home and abroad and to utilize our resources for the high purposes of promoting world peace and world prosperity, a common sacrifice lies ahead to protect this nation from any weakening of its economy and to guarantee that our great strength, which is the hope of mankind, shall be preserved. (Applause)

REMARKS

CHAIRMAN LEFFINGWELL: We are all grateful to you, Mr. Secretary, for coming here and honoring the Academy by your fine and thoughtful address.

Canada's contribution to the war effort and to reconstruction after the war has been magnificent. Her coöperation with the United States and with Great Britain has been effective and generous. Her problem since the war, like the problem of the mother country, has been that she has had to buy here many of the things she needs and to pay for them in United States dollars. And in the nature of the case, and by long habit and custom, she has found the market for the things she has had to sell largely in Great Britain and other countries which are short of United States dollars.

The future of the world of free men greatly depends upon the strength and durability of the British Commonwealth of Nations. So does the welfare of our own beloved country. We cannot dwell in peace and freedom alone. Canada, in economic strength, in the hardihood and loyalty of her citizens, is one of the most important of the nations of the British Commonwealth. We, Canada's neighbors in North America, are proud of her, and we are her loyal friends; all the more because we admire and applaud her loyalty to the British Commonwealth and to her King.

Our guest, the Canadian Minister of Finance, was born in Quebec in 1899. Before he was eighteen years old he went to France and served there from 1916 to 1918, and was commissioned a Second Lieutenant in the Royal Air Force. After the First World War he studied law at McGill University, of which by the way our honored President, Lewis Douglas, was, you will recall, at one time Principal and Vice Chancellor. In 1921 Mr. Abbott returned to France and studied Roman law at Dijon to prepare himself for the practice of the law in Quebec; for the Quebec civil code is based on Roman law. Mr. Abbott practiced law in Montreal and became a King's Counsel in due course. He was elected to Parliament in 1940, and in 1943 became Parliamentary Assistant to the Minister of Finance. In that capacity he was particularly responsible for the administration of the wartime Prices and Trade Board. Any one who survived that ordeal must be good. He later became Assistant to the Minister of National Defense, Minister for National Services and Minister of National Defense, and finally, at the end of 1946, Minister of Finance. I have the honor to present to you the Honorable Douglas Charles Abbott, Minister of Finance of Canada. (Applause)

The Honorable Douglas C. Abbott: Mr. Chairman, Mr. Secretary, Ladies and Gentlemen: First let me thank you, Mr. Chairman, for the very generous things which you have said about my country and about myself, which I can assure you are deeply appreciated.

I am in somewhat the same position as my friend, the Under Secretary of the Treasury. I have come here with an address which I am afraid could hardly be described as inspirational, but I was asked to speak on the subject of "Prices and Credit", and I felt that since I had been asked to speak on that subject, I should follow my instructions.

PRICES AND CREDIT

THE HONORABLE DOUGLAS C. ABBOTT
Minister of Finance of Canada

WHEN I accepted the kind invitation of your President to speak to you on this subject of " Prices and Credit ", I assumed that you would not expect me to attempt any economic dissertation on the controversial causal relationship between credit and prices but rather to give you some of the facts and the lessons of Canadian experience in this field.

Problems connected with the practical aspects of price control and price decontrol and the adaptation of fiscal and monetary policies to the changing economic situation have occupied a very large proportion of my waking hours during the last two or three years. Nevertheless, I am a layman and I have no desire to split hairs with the economists in a field of doctrine concerning which, as one of them has said, not more than a half dozen economists are able to argue with any real comprehension of what they are talking about! Therefore, I shall not take sides in the controversy as to whether it is expansion in the supply of money or credit [1] that drives up prices or whether it is rising prices that force expansion in the supply of money or credit. I suspect that at certain times the primary impulse comes from the money side and at other times from the goods side but I am confident that, whichever comes first, a point is reached where each feeds upon the other. That, it seems to me, is what is important from the *practical* point of view of those of us who are concerned with policies and remedies.

The most conspicuous economic fact of the last two years has been the upward spiraling of prices all over the world. It is not a local problem. It is not confined to any one country or to any group or class of countries. It is a world-wide phenomenon. It appears to be the inevitable sequel to the physical destruction, the disruptions of production and trade, and the enormous credit

[1] In this paper I shall use these two terms interchangeably.

expansion caused by war; for, as night follows day, this type of phenomenon has followed each of the four major wars of the last century and a half. Thirty months after the end of World War II, the world from the price point of view stands very much where it stood a short time after the Napoleonic Wars, after the United States Civil War and after World War I.

We in Canada have not been able wholly to escape the effects of this world-wide epidemic, although our economy was untouched by the physical ravages of the war; we succeeded in increasing our production of goods enormously, and we vigorously pursued bold anti-inflationary policies. In the first war budget, delivered on September 12, 1939, the day after Canada declared war, the Canadian government committed itself to a pay-as-you-go policy carried to the farthest practicable limit. Arguing that the real resources required to fight a war must come almost wholly from current production, the Minister undertook to finance Canada's war effort by raising taxes to the highest tolerable point and by borrowing as much as possible of any needed additional funds out of current savings rather than by the inflationary expansion of money and credit. At that time no one dreamed that Canada would find it necessary or even possible to mobilize the war effort which was later to be her share. It became an all-out effort and it cost Canada something of the order of $20 billion. It was extremely fortunate, therefore, that from the very start of the war Canada was committed to this type of financial policy.

Those who are familiar with the record will agree, I think, that the policy was carried out with great vigor and determination. New and higher taxes were imposed with a Draconian severity and in the end over 53 per cent of all government expenditures during the war was financed out of tax revenues. Similarly, the record achieved in mobilizing the savings of the public was a good one. A nation-wide and increasingly efficient organization was developed which in two War Loan and nine Victory Loan campaigns succeeded in raising over $12.2 billion of new cash. It was, however, impossible for the government to avoid some use of the banking system as a direct source of borrowing, and the public was also responsible for an expansion of bank credit through temporary borrowings to assist in Victory Loan purchases and through some selling of bonds

to the banking system in between loan campaigns. According to the calculations of the Bank of Canada, however, the total increase in money supply between the end of 1939 and the end of 1945 was only $2.1 billion, or roughly 156 per cent.

It was this fiscal and financial policy that, by " mopping up " surplus purchasing power, really made possible the success of our direct wartime controls of prices and wages. In the late thirties, prices had not recovered from the disastrously low levels of the depression. The outbreak of war, with its threat of commodity shortages, stiffened prices sharply all over the world, and in our case the price rise was amplified by a 10 per cent reduction in the external value of the Canadian dollar. In the summer of 1941, as Canada and other countries began to cross into the zone of full employment, inflationary pressures began increasingly to assert themselves. It was under those conditions that in October of that year Canada imposed its complete, over-all ceiling on prices. At the same time a ceiling was placed on wages and salaries and a little later the excess profits tax was raised from 75 per cent to 100 per cent. For successful administration it became necessary to supplement the price-ceiling program with a vigorous combination of supply controls, production directives, export controls, bulk purchasing, subsidies and rationing.

This " tough " and realistic policy, ably administered and firmly enforced, succeeded in holding the general level of retail prices in Canada almost completely stable for more than four years. From October 1941 to December 1945, the index of the Canadian cost of living rose by only 4 per cent and the rise in wholesale prices was only 10.6 per cent. Our wartime policies had thus succeeded to a remarkable extent in holding the evils of inflation in check. We had enormously increased our production and maintained a reasonable balance in our economy. By preventing a headlong upward rush of prices, we had kept down the money cost of the war and the continuing burden of war debt, safeguarded the economically vulnerable members of our population against acute hardship, and avoided the acute social unrest, with its damaging effect on output, which is the product of sudden and drastic price changes.

After the war ended we were anxious to maintain indefinitely as much of these solid gains as was practicable in a world in which no nation any longer lives unto itself alone. We were

hopeful, therefore, that throughout the world the pressure of inflationary forces could be held in check—by expanding output, by appropriate fiscal, monetary and economic policy in all countries, and by constructive international coöperation. We believed in a free economy and in the effective working of the price system and we realized that even if we wished to do so we could not under ordinary peacetime conditions maintain that practically unanimous public support upon which the successful administration of price control is dependent. At that time also it was widely believed that a fall of moderate proportions in the world price level was likely in the relatively near future. Therefore, as our price level was below that of most other countries, we hoped that we would be able to tie on to the probable new world level of prices without too great an upward adjustment in our own prices.

When we first began to think of the problem of decontrol, away back in 1944, we felt that our plans for dismantling our wartime restrictions should be spread over a period of at least two years. While always ready to adapt our plans to unforeseen developments—and having to do so on more than one occasion—we have nevertheless kept pretty well to that original schedule. Our supply controls were relaxed very quickly and by the end of 1945 most of them had disappeared. Price and rationing decontrol, however, was not even begun until February 1946, and for more than a year after that it took place very gradually and cautiously. Not until the spring of 1947 did we begin to decontrol and deration the staple constituents of the peoples' food, clothing and shelter. The elimination of subsidies was a necessary prerequisite to the decontrol of prices. It began early in the post-war period and was accelerated after about the middle of 1946. By that time, United States price controls had been substantially eliminated and it had become clear that there was little hope of subsidies being eliminated by external prices moving down to the Canadian level and that as the remaining subsidies were withdrawn price increases would follow in most cases.

During the year 1947 the removal of subsidies and the decontrol of prices proceeded apace and we had in mind the possibility, if not the probability, of complete decontrol by the spring of 1948. That has proved somewhat optimistic, but by the beginning of this year all that remained of price control were the ceil-

ings on wheat, sugar, oils and fats, soap, shortening, tin, and primary iron and steel. In addition, we continued and still continue our rent and eviction controls. Under its emergency powers the government still retained the power to reimpose price ceilings whenever conditions warranted, and the sharp further upswing in prices early this winter caused the government to exercise these powers in the case of butter, cabbages and most canned fruits and vegetables. The government has also requested and received from Parliament the right to continue its price-controlling powers for another year, that is, to March 31, 1949. It has made it very clear, however, that it regards these as emergency powers and that it does not intend to go back to any general or over-all system of price control. It is using its powers only to place specific controls on those sections of the price structure which appear to be getting out of line.

This program of decontrol, we believe, has been an orderly and well-considered one. It has followed a logical pattern and avoided the two extremes: on the one hand, the extreme of sudden withdrawal of all controls, leaving economic forces to adjust themselves to the new situation overnight and therefore chaotically; and, on the other hand, the extreme of retaining for too long a full-fledged control program with its probable inevitable effect in restricting production and aggravating the problems of readjustment that must ultimately be faced. Despite the orderliness and the gradualness of the decontrol program, however, it has been accompanied by an increase in the price level of fairly sizable proportions. Between December 1945 and February 1948, the index of the Canadian cost of living increased by 25 per cent, and the index of wholesale prices by 41.8 per cent. These increases are somewhat higher than the corresponding increases in a few other countries during the same period, but this is a reflection of the fact that Canada, at the end of 1945 and in relation to pre-war levels, showed smaller increases than almost any other country. Last December, in respect of our cost-of-living index we were still below all the other fifty countries for which figures are reported in the United Nations *Monthly Bulletin of Statistics,* excepting only Australia, New Zealand, Southern Rhodesia and the United Kingdom.

This suggests that the *major* explanation of our recent price rise lies in price-raising factors outside our borders. Canada

ranks as the third largest importer and exporter of goods in the world. In these circumstances we could not hope under normal conditions to insulate ourselves from the effects of the inflationary rise in prices throughout the world. With the coming of peace, the elaborate system of controls and subsidies, both on domestic goods and on imports and exports, with which we had safeguarded ourselves during the war had had to be withdrawn, piece by piece, and the Canadian structure had therefore been left more and more exposed to external influences.

I have no desire to belittle the domestic factors which contributed to the over-all result. A considerable part of the rise in the cost-of-living index over the past two years has been due to the cessation of subsidy payments and the widening of dealers' and manufacturers' margins following the release of controls. The most important factor, however, has been the boom which has been developing in my country as in yours. Despite the magnitude of the industrial reconversion problem with which V-J Day confronted us and the large number of enlisted men and of war workers for whom new peacetime occupations had to be found, Canada made the transition from a wartime economy to a peacetime economy with astonishing speed and smoothness. In a little over a year we were again passing into a zone of full employment and since then we have been witnessing a real economic boom, particularly in the field of consumer goods and industrial capital expenditures. It is a boom of unprecedented proportions even though the public does not seem to be aware of it—thanks largely, I suppose, to the abnormal way in which the usual barometer, the stock market, has been acting. Our gross national production has increased from $11.6 billion in 1945 to over $13 billion last year—in 1938 it was $5.1 billion. Personal expenditure on consumer goods and services increased from $6.8 billion to $8.7 billion in the last two years. In 1947 the grand total of new capital investment in Canada, including investment by industry, institutions, governments, farmers and housebuilders, reached the unprecedented total of $2.4 billion. A recent survey, based on current intentions, forecasts a comparable figure for 1948 at $2.8 billion. To convert into your terms, these figures would have to be multiplied by about 18.

Activity of this degree of intensity naturally exerts a severe strain on our economy and on our cost and price structure. Par-

ticularly in the case of labor, materials and equipment used in capital goods expansion, the pressure of demand has been and still is intense. This level of demand is not too concerned about price and therefore not too inclined to resist the upward trend in costs and prices. Capital expansion and high industrial activity in Canada always mean heavy imports of United States machinery, equipment and materials—chiefly coal, cotton and petroleum products. High incomes in Canada similarly mean heavy importation from the United States of consumers' durable goods and many luxuries or semi-luxuries. When this happens at a time when we are financing a substantial portion of our exports to Europe on credit, the inevitable result is a drain on our exchange reserves. We still have, I should emphasize, an overall surplus in our current account with all countries, a very large one in 1946 and one not so large in 1947, but in both cases this current account surplus was not as large as the volume of our exports financed on credit or given away. We have, as you know, put into operation a comprehensive program to correct the drain on, and to replenish, our reserves, and that program, I am glad to be able to report, is working—much better indeed than we had expected. It is pertinent for our present purpose, however, to note that the effect of the import restrictions which form an important part of the program is to exert still further pressure upon prices.

In the face of the developing post-war boom, we have tried to adapt and develop our fiscal and monetary policies in such a way as to restrain excesses without endangering full employment and maximum production. Never before has there been so great a world need for the maximum output of this Western Hemisphere, and our problem, it has seemed to us, is to keep the productive car rolling along at optimum speed, avoiding both the reckless speed that would soon lead to disaster and the too sudden or too drastic braking that would skid the car into the ditch. This type of consideration was primarily responsible for the gradualness and orderliness with which we dismantled our wartime price controls, which I have already described. It has had an equally important influence on our policies in the field of credit and finance.

As far as fiscal policy is concerned, we have consciously followed a policy of maintaining taxes at such a level as would pro-

duce substantial surpluses in our government accounts. True, our rates of tax on personal incomes have been cut substantially from the very high levels of wartime because they were threatening to impair output and undermine enterprise. But they are still very high as compared with pre-war levels. The excess profits tax was gradually reduced and finally eliminated only as from the first of this year. Corporations now pay to the Dominion government a tax of 30 per cent on net profits. The rest of the wartime tax structure stands very nearly intact. As a result of these high tax rates and of high incomes and business activity, total government revenues have been maintained at abnormally high levels. Last year I was able to report a substantial surplus and, for our latest fiscal yeaı which ended yesterday, I shall be reporting to Parliament in a budget speech a few weeks hence another surplus of such a magnitude as to bring a glow to the heart of any Canadian Minister of Finance. Under our accounting system, these surpluses are calculated before taking account of investments and loans, including those to governments abroad, so that in fact we have invested a considerable portion of them in such so-called active assets. A substantial part of these surpluses, however, has been available and has been used to retire public indebtedness.

While we have been using surpluses in part to pay off public debt, we have deliberately continued into the post-war period the wartime practice of carrying on nation-wide campaigns to sell government securities of the savings type to industrial workers and to persons of small or moderate incomes. Since October 1946, the total sales of these National Savings Bonds, less redemptions, have amounted to $663 million. At first, as the inflationary pressure was not so strong, the dominant motive was to provide an opportunity for the small investor to continue the salutary habit of saving he had acquired in wartime. Increasingly as time has gone on, more recognition has been given to the value of these campaigns in mopping up purchasing power and easing the inflationary pressure.

I wish now to say a word about the effects of the government's fiscal and financial policy upon the banking system. Direct financial assistance by the banking system to the government reached its peak in October 1945, when holdings, by the Bank of Canada and the chartered banks, of deposit certificates and

other Dominion securities designed especially for the banking system reached $2¼ billion. From that date to the end of December last, out of our surpluses of cash receipts over expenditures and out of the proceeds of public borrowings, the government was able to reduce the total of such banking securities by $1.4 billion. This reduction in the banking system's holdings of such securities represents about half the amount of the wartime increase in money supply resulting from government financing. Of this reduction, $782 million had occurred by December 1946, and the balance of $665 million took place in the calendar year 1947. These figures, it seems to me, demonstrate pretty clearly the extent to which the government's postwar fiscal policies have attacked the problem created by wartime credit expansion.

During the latter part of the war, a substantial part of the increase in money supply took place because the people on balance were net sellers of government bonds during the months between bond-selling campaigns; and most of these bonds of necessity ended up in the portfolios of the banking system. It is true that there was at the same time a very considerable expansion in idle savings deposits, but not to the full extent of the banking system's increased holdings of bonds. Contrary to some prevailing opinion, however, sales by the general public of its accumulated holdings of government bonds have not been a factor increasing credit expansion during the past year or so. In 1946 the banking system's holdings of government bonds and of temporary loans made to assist Victory Loan purchases increased by only $93 million, while in 1947 government bonds held by the Bank of Canada and the chartered banks actually declined by $27 million.

I should state at once that, in spite of the large reduction in money supply which the government's fiscal policy has effected, our *total* money supply has not declined during the past two years. On the contrary, according to the Bank of Canada's calculations, the supply of money in Canada increased from $3.5 billion at the end of 1945 to $3.9 billion at the end of 1947. The reason for this was the large increase in loans made by the chartered banks and in their holdings of securities other than those issued by the Canadian government. At the end of December last, the total of these two types of assets in their port-

folios was not far from double what it had been on December 31, 1945. Important as factors accounting for this large increase were increases in loans to and securities of provincial and municipal governments, increases in loans to manufacturers and merchandisers, probably due in large part to higher inventories, increases in loans for consumer credit purposes, and increases in loans to and securities of business firms made or issued for capital development purposes.

The monetary policy which has been followed in the last two years has been of a type designed to supplement the restraining effect of the government's policy of paying off debt out of current surpluses. As a result of central bank action, for instance, the average cash reserve of the chartered banks has been maintained at a slightly lower level in 1946 and 1947 than at the end of 1945, although the effectiveness of this action was weakened to some extent by the willingness of the banks to let their cash ratios run down a bit.

I might mention another development of some interest in the field of monetary policy, though it was instituted for other reasons as well. This was a voluntary agreement negotiated with the chartered banks in the opening months of 1946. To understand this arrangement, it should be remembered that we have practically no specialized savings institutions in Canada and that our chartered banks perform this public function as well as those of ordinary commercial banks. Under this arrangement, the banks agreed that their holdings of Dominion government domestic bonds would not average more than 90 per cent of their Canadian savings deposits and that by appropriate selection of an average term their earnings on such bonds held for investment account would not exceed their operating costs on Canadian savings deposits by more than a moderate profit margin for this type of banking business. This profit margin was to be subject to review from time to time. If the banks should wish to invest in Dominion bonds beyond the amount recognized as appropriate in connection with their Canadian savings deposits, they were to avail themselves of Treasury Bills or other short-term securities bearing an appropriate low rate of interest. If perhaps the primary purpose of this agreement was to restrict to reasonable proportions the earnings of banks from holding government bonds, a second purpose was to prevent banks from

being unduly aggressive buyers of government bonds in the market, which might have the effect of dislodging general public holdings of such securities and perhaps lead to some increase in the supply of credit.

It used to be the orthodox view, and it is a view still held in some quarters, that the solution to the type of situation which exists today is to allow interest rates to rise to increase the supply of savings and to choke off the demand for them. During 1947, especially in the latter part of the year, interest rates did stiffen in the United Kingdom and the United States, and since the first of this year in Canada the yield on long-term government bonds has risen in two steps to the level on which the Victory Loans were raised during the war—that is to say, 3 per cent. However, I do not think this should be interpreted to mean any conviction on the part of our monetary authorities as to the efficacy of interest-rate changes as an instrument for controlling credit expansion under current conditions. In commenting on the reduction in its bid prices for government bonds on February 27 last, the Bank of Canada used the following words:

> The degree of the change in interest rates does not appear inappropriate in the circumstances. On the other hand the Bank of Canada does not regard the increase in rates which has taken place as one of the most important factors in combatting a general rise in price levels. The bank is not in favor of a drastic increase in interest rates which would be likely to create a situation that might hamper, and might even prevent, essential forms of capital investment which Canada needs and which it is desirable should be proceeded with.

Perhaps I might amplify this statement a little. On the supply side, it is difficult to believe that any reasonable increase in interest rates would persuade the general public to save more and increase on balance its holdings of government bonds, thus making possible effective open market operations by the central bank. During the war the public in all democratic countries was persuaded to increase its holdings of government bonds on a scale far beyond anything previously dreamed of. A rise in interest rates likely to be sufficient to induce the public to increase its savings materially under present conditions would cause so drastic a fall in the prices of such bonds and so chaotic

a condition in the money market and among institutional as well as individual investors that I doubt whether any responsible person would recommend it as deliberate policy. Even if the public should increase its purchases of government bonds, this would not be anti-inflationary unless the purchasers, in doing so, increased their current savings. A switch from idle savings deposits to bonds would not be enough, and it is difficult to believe that most of the small savers are likely to reduce their living expenditures under current conditions merely because they can obtain a slightly higher interest rate on the money they save.

Analysis of the demand side of the market leads to a similar conclusion. From the point of view of the industrial borrower, demand is so intense that it would take a really substantial change in interest rates to dampen his enthusiasm and make him defer his capital project. Difficulty in obtaining loans or in floating securities would be a much more effective deterrent than higher rates. It would, of course, be comparatively easy for the central bank to produce such chaotic conditions in the money market that even the largest and strongest corporations would have difficulty in raising money. But as I have already indicated, what we need is a slowing down, not a sudden cessation, of capital development.

In general I would expect this to be substantially the philosophy which animates the monetary authorities in your country and in the United Kingdom.

In conclusion, may I say that the remaining type of remedial influence on which we have placed some reliance is that of information and moral suasion. Those of us who have some responsibility in these matters have tried to disseminate information and understanding as to the nature and significance of prevailing economic trends. Probably of greatest importance in this connection is the influence of our central banking authorities. The annual reports of the Bank of Canada are models of penetrating economic analysis and replete with fruitful suggestion, express or implied. I know also that officials of the Bank are in frequent consultation with the management of the chartered banks and I am sure there is a continuing exchange of views as to changing developments and the actions and policies appropriate to each new development. Such exchange of

information and opinion between central bank and commercial bank officials and between bank officials and business men is, it seems to me, exceedingly valuable.

It may not be wholly effective at a time when the prevailing psychology of business men and the public is expansive. But it is most in accordance with our democratic way of doing things, it is flexible and it may indeed be very effective if all the relevant facts are made available and their meaning discussed by a sufficient number of the leaders of business and of public opinion.

The Academy of Political Science is helping to do that by devoting this semi-annual meeting to a discussion of what is probably the most important of our current economic problems. (Applause)

Remarks by the Chairman

Chairman Leffingwell: We are all very grateful, Mr. Minister, for this interesting and admirable speech.

It is the privilege of the presiding officer on such an occasion as this, or, if not his privilege, within his power, to make a few remarks on his own account; and he may well get away with it if he makes them very few.

Fiscal policy and debt management in the United States, and prices and credit in Canada, all the plans of both governments for the orderly handling of these important affairs, are necessarily subject to what happens abroad. The best laid plans of our finance ministries will go astray if Europe starves or if war comes. We have been warned by our government of the gravity of the crisis in western Europe, and of the gravity of the crisis in our relations with Russia.

I believe in our constitutional system of government, and in our ability to make it function in time of crisis; even though the crisis is inconsiderate enough to occur in a presidential election year. Perhaps "inconsiderate" is not the right word. Perhaps the Russians planned it that way; perhaps it was deliberate. Mr. Harold Laski put this point rather neatly on his arrival on the Queen Elizabeth last week. Said he: "The gentlemen in the Kremlin think that your policy is semi-paralyzed until November. They are gathering rosebuds while they may."

True, we walked out of the councils of the nations in 1920, a presidential election year, and became fully isolationist. We let the domestic crisis go from bad to worse in 1932, a presidential election year. After that election we exaggerated our isolationism and passed the Johnson Act black-listing our allies for nonpayment of debts, abandoned the freedom of the seas and the right to trade freely with belligerents; and we did not act as though we cared much whether the Germans conquered the whole of Europe or not, until 1940, when the second German war had been going on in Europe for a year.

Now, we are doing better. The Marshall Plan has passed both Houses. Our country has found a unity on foreign policy under such able leaders, in the Administration, as Secretary Marshall and our friends and neighbors Robert Lovett, Lewis Douglas and James Forrestal, and, in Congress, as that great statesman, Senator Arthur Vandenberg. In this great crisis of the world and of our country, national unity in support of the foreign policies of our government, national unity for the defense of freedom, or of what is left of it in this sad world, will prove the capacity of our constitutional government to function effectively.

Until peace and law and order are restored in the world, and some measure of assurance is given to the suffering people of Europe, or what is left of them west of the Stettin-Trieste line, that the Russian avalanche will not grind over them too, there cannot be full European recovery and rehabilitation. When I hear the critics of the Marshall Plan complain of the progress that has been made in Europe, and very great progress has been made, I think to myself of one who, when he saw some poor forlorn fellow passing by, said to himself: "There but for the grace of God go I." Are we better off because of the superior virtue and intelligence and diligence of us Americans; or just by the grace of God, and of the fact that our ancestors came over here centuries or decades ago, took possession of a great continent, and put some thousands of miles of ocean between us and the aggressor states? Is it because of our peculiar virtue, or by the grace of God, and of the fact that other nations resisted Germany for two or three years before either the First or Second World War was forced upon us?

The United Kingdom alone among the victorious Powers fought both wars from the beginning to the end. In the process Britain spent the lives and health of her young men and the accumulated wealth of centuries. Is it for us to say that these gallant people, who bore the brunt of both wars for so long, and the brunt of the Second War alone so long, are to be condemned because they have not succeeded yet in straightening out the problems resulting from the sacrifices they made in the victorious wars they fought?

It was six years, from 1918 to 1924, after the First War, before reconstruction was under way in Europe. Yet there was no nation fighting reconstruction and recovery then, as Russia is fighting reconstruction and recovery now. Are we to be despondent because, in spite of the all-out effort of Russia to sabotage reconstruction and recovery, Europe has not yet achieved recovery in three years? Of course Britain and western Europe can and will recover.

I have no doubt at all that, if we vigorously support our government in its policy of help to western Europe, we shall achieve our objective. Only a policy of penuriousness and weakness at this critical hour in human history could result in disaster to Europe and to ourselves. We must be strong. We must be united as a people. We must be of one mind for the recovery and defense of what is left of the free world.

I am sure I speak for you all when I thank the Minister and the Under Secretary for their graciousness in coming here and discussing and explaining the policies of our two governments. And now I declare the meeting adjourned.